S.E.C.

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

REPORT

OF THE

SECURITIES AND EXCHANGE COMMISSION

PURSUANT TO SECTION 30 OF
THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

PART THREE

CHAPTERS III, IV, AND V

Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies

WASHINGTON, D. C.

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LETTER OF TRANSMITTAL

Securities and Exchange Commission,
Washington, D. C., December 29, 1939.

Sir: I have the honor to transmit herewith Chapters III, IV, and V of Part Three of the Commission's report on the study of investment trusts and investment companies made pursuant to Section 30 of the Public Utility Holding Company Act of 1935.

Chapter III deals with the problems in connection with the distribution and repurchase of shares of open-end and closed-end management investment trusts and investment companies; Chapter IV discusses the problems in connection with shifts in control, mergers, and consolidations of management investment companies; and Chapter V deals with the problems in connection with capital structure.

The study and report were under the general supervision of Commissioner Robert E. Healy, with Paul P. Gourrich, former technical adviser to the Commission, as director of the study; the late William R. Spratt, Jr., as chief of the study; David Schenker as counsel; and L. M. C. Smith as associate counsel. Mr. Justice Douglas, former Chairman of the Commission, whose resignation from the Commission was submitted on April 14, 1939; Paul P. Gourrich, former director of the study, whose resignation from the Commission was submitted on March 31, 1939; and William R. Spratt, Jr., former chief of the study, whose death occurred on June 20, 1938, did not participate in the preparation or consideration of Part Three.

Collaborating on the preparation of Part Three was a group under the immediate supervision of David Schenker and L. M. C. Smith. Chapter III was prepared under the supervision of Charles E. Shreve; Chapter IV under the supervision of Harry Heller; and Chapter V under the supervision of Emanuel Bublick.

By direction of the Commission:

Jerome N. Frank, *Chairman.*

The President of the Senate.
The Speaker of the House of Representatives,
Washington, D. C.

LIST OF REPORTS SUBMITTED

Part One, Part Two, and Chapters I and II of Part Three of the overall report have heretofore been transmitted by the Commission to the Congress. Part One, which was transmitted by the Commission to the 75th Congress on June 10, 1938, consists of a discussion of the nature, classification, and origins of investment trusts and investment companies, and has been printed as House Document No. 707, 75th Congress. Part Two, the transmission of which to the 76th Congress was completed on March 10, 1939, consists of a statistical survey of investment trusts and investment companies and has been printed as House Document No. 70, 76th Congress. Part Three, the transmission of which to the 76th Congress was begun on April 29, 1939, deals with the abuses and deficiencies in the organization and operation of investment trusts and investment companies and has been ordered printed as House Document No. 279, 76th Congress.

The Commission has also transmitted to the Congress six supplemental reports, namely: Investment Trusts in Great Britain, transmitted on June 26, 1939, and printed as House Document No. 380, 76th Congress; Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, transmitted on August 17, 1939, and printed as House Document No. 477, 76th Congress; Commingled and Common Trust Funds Administered by Banks and Trust Companies, transmitted on August 30, 1939, and printed as House Document No. 476, 76th Congress; Companies Sponsoring Installment Investment Plans, transmitted on September 22, 1939, and printed as House Document No. 482, 76th Congress; Fixed and Semifixed Investment Trusts, transmitted on January 15, 1940, and printed as House Document No. 567, 76th Congress; and Companies Issuing Face Amount Installment Certificates, transmitted on March 13, 1940, and printed as House Document No. 659, 76th Congress.

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Chapter III

PROBLEMS IN CONNECTION WITH THE DISTRIBUTION AND REPURCHASE OF SHARES OF OPEN-END AND CLOSED-END MANAGEMENT INVESTMENT TRUSTS AND INVESTMENT COMPANIES

I. PROBLEMS RELATING TO THE DISTRIBUTION AND REPURCHASE OF THE SHARES OF OPEN-END MANAGEMENT INVESTMENT TRUSTS AND INVESTMENT COMPANIES

A. The Open-End Concept

The practices in connection with the distribution and repurchase of the shares of open-end management investment trusts and investment companies constitute the distinguishing characteristics of this type of investment vehicle. While other factors, such as capital structures, investment policies and management discretion appear to distinguish open-end investment companies, an analysis reveals that they all spring from the distribution and repurchase practices. Accordingly, a discussion of the possible abuses in the distribution and repurchase of the shares of open-end investment companies must necessarily be much more inclusive than the treatment accorded the same subjects in connection with closed-end management investment companies.

1. DISTINGUISHING CHARACTERISTICS

The distinguishing characteristics of open-end management investment trusts and investment companies are more particularly defined as:[1]

(a) The continuous offering of securities at prices which will net the fund amounts equivalent to the net asset value of each outstanding share at the time of sale; and

(b) The obligation of the investment company to redeem or repurchase its outstanding shares by paying the equivalent of the net asset value per share (in some cases less a small redemption fee).

Of these two characteristics, the obligation to redeem at net asset value is the more significant. Accordingly, investment companies have been classified as open-end if their shares have been redeemable

[1] Most fixed investment trusts and installment investment plans also possessed these characteristics as to sales and redemption, but have marked structural differences. (See the Commission's supplemental reports on Fixed and Semifixed Investment Trusts and Installment Investment Plans.)

at asset value even though they are no longer continuously distributed.[2]

A typical charter provision covering the repurchase of outstanding shares by an open-end management investment trust or company is as follows:[3]

> Each holder of the capital stock of the Corporation shall be entitled to require the Corporation, to the extent that the Corporation shall have any surplus available for such purposes and out of such surplus, to purchase all or any part of the shares of the capital stock standing in the name of such holder on the books of the Corporation, at the liquidating value of such shares. The method of computing such liquidating value shall be computed and the time of payment therefor shall be determined as hereinafter in this certificate of incorporation provided. The Corporation shall, to the extent necessary, sell any securities held by it to provide cash for the purchase of its shares.

As of December 31, 1935, a study was made of the redemption provisions of 8 open-end investment companies organized as Massachusetts or business trusts and 30 organized as corporations, to consider the possible abrogation of such feature.

In the case of three New York business trusts, stockholders dissenting from any amendment to the trust indenture were entitled to have their stock redeemed. In the case of five trusts organized in Massachusetts it was provided that the indenture or declaration of trust could be amended if the directors so decided, provided a majority of the certificate holders assented. In only one case was the assent of two-thirds of the certificate holders required. Although abrogation of the redemption feature would seriously impair the rights of the minority who did not assent thereto, these certificate holders would nevertheless presumably be without remedy, since they were expressly bound by all the provisions of the trust indenture, including the provisions for amendment.

Of the 30 open-end investment companies organized as corporations, seven were incorporated under the laws of Massachusetts, seven under the laws of Maryland, fourteen under the laws of Delaware, and two under the laws of the Dominion of Canada. Almost all of the corporate charters which contained redemption provisions limited redemptions to "surplus," "assets," or "funds" legally available therefor, as required by corporation laws of various states.[4] Likewise, almost all the charters expressly or by implication provided for suspension of the redemption privilege for such period as the New York Stock Exchange should be closed. Four corporations reserved the right to withhold payments for a period of 60 days, and others for somewhat lesser periods.

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[2] For example, State Street Investment Corporation discontinued selling new stock on June 22, 1935, but it is here classified as open-end because of the redemption privileges attached to the stock.

[3] Reply to the Commission's questionnaire for Dividend Shares, Inc., Pt. I (Exhibit 3–b).

[4] State Street Investment Corporation was not forced to suspend its stock repurchases when its capital was impaired because in Massachusetts a corporation may repurchase its own shares even though capital is impaired, so long as it is able to meet its debts and obligations as they mature. (See *Crimmins & Pierce Co.* v. *Kidder Peabody Acceptance Corporation*, 185 N. E. 383, 83 A. L. R. 1122.) The Maryland law recently made a specific exception for investment companies. (General Corporation Law of Maryland, Art. 23, Sec. 50 (8).)

In addition, in six cases it was found that the entire redemption privilege rested on a perilous foundation. The charter of State Street Investment Corporation was silent as to any redemption rights on the part of stockholders. The repurchase policy of this corporation was originally defined by a resolution of the Board of Directors on December 30, 1927, and subsequently on September 23, 1931, was redefined by a vote of the stockholders.[4a] The charter of Wellington Fund, Inc., was likewise silent as to redemption rights, the provision being incorporated merely in the corporation's bylaws, which could be amended by the Board of Directors. Spencer Trask Fund, Inc., and Premier Shares, Inc., had no redemption provisions in their certificate of incorporation, the former setting forth the redemption privilege in a contract between itself and the fund manager, the latter in an indenture pursuant to which the shares have been issued. Quarterly Income Shares, Inc., and The Maryland Fund, Inc., provided in their certificates of incorporation that they would redeem their shares only until they should be listed on a stock exchange (in any city of 2,000,000 or more population) and thereafter if the Board of Directors permitted. The Maryland Fund, Inc., has recently suspended redemption, after having listed its shares on the Board of Trade of the City of Chicago. In the case of Quarterly Income Shares, Inc., the charter was amended on October 29, 1936, to provide that the right of redemption could not be rescinded by the Board of Directors. However, on February 15, 1940, the Board of Directors revised the redemption provision so that the price received by the redeeming stockholder would not be determined until the 364th day after his notice of redemption.[4b]

The necessity for sales as a corollary to redemption provisions was usually recognized in the trust indentures or charters of these open-end investment trusts and investment companies by provisions for continuous offerings of their securities and waiver of preemptive rights of stockholders. A typical provision is as follows:[5]

> Any authorized but unissued stock, as well as any treasury stock, may be sold from time to time, by authority of the Board of Directors, without first being offered to the existing stockholders, at a price to net the company not less than its liquidating value determined as hereinafter provided. The Board shall from time to time determine what sum if any shall be added to the liquidating value of a share to fix the net selling price.

While limitations upon management discretion were at first common in open-end investment companies, such provisions were more characteristic of the period during which they attained wide distribution than of the vehicle itself. These limitations have since been somewhat relaxed.[6] However, the abandonment of all restrictions upon management discretion was discouraged by the provisions of the Revenue Act of 1936, granting special treatment to so-called "mutual investment companies."[7] In order to qualify as a "mutual investment

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[4a] Reply to the Commission's questionnaire for State Street Investment Corporation, Pt. V.

[4b] Registration Statements, 1934 Act, for Quarterly Income Shares, Inc. (File No. 1–1950–2) and Registration Statement, 1933 Act, for The Maryland Fund, Inc. (File No. 2–3144–1).

[5] Reply to the Commission's questionnaire for Incorporated Investors, Pt. I (Exhibit II).

[6] See infra, pp. 820–23 and Ch. I of this part of the report, pp. 26–31.

[7] For further discussions of this provision of the Revenue Act see Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II, pp. 83–5, and Ch. III, note 47, p. 212.

company" under that act and obtain a tax preference [8] the investment company had to meet the terms of the following definition: [9]

(1) *General definition.*—The term "Mutual Investment Company" means any corporation (whether chartered or created as an investment trust, or otherwise), other than a personal holding company as defined in section 351, if—

(A) It is organized for the purpose of, and substantially all its business consists of, holding, investing, or reinvesting in stock or securities; and

(B) At least 95 per centum of its gross income is derived from dividends, interest, and gains from sales or other disposition of stock or securities; and

(C) Less than 30 per centum of its gross income is derived from the sale or other disposition of stock or securities held for less than six months; and

(D) An amount not less than 90 per centum of its net income is distributed to its shareholders as taxable dividends during the taxable year; and

(E) Its shareholders are, upon reasonable notice, entitled to redemption of their stock for their proportionate interests in the corporation's properties, or the cash equivalent thereof less a discount not in excess of 3 per centum thereof.

(2) *Limitations*—Despite the provision of paragraph (1) a corporation shall not be considered as a mutual investment company, if subsequent to a date thirty days after the date of the enactment of this Act, at any time during the taxable year—

(A) More than 5 per centum of the gross assets of the corporation, taken at cost, was invested in stock or securities, or both, of any one corporation, government, or political subdivision thereof, but this limitation shall not apply to investments in obligations of the United States or in obligations of any corporation organized under general Act of Congress if such corporation is an instrumentality of the United States; or

(B) It owned more than 10 percentum of the outstanding stock or securities, or both, of any one corporation; or

(C) It had any outstanding bonds or indebtedness in excess of 10 per centum of its gross assets taken at cost; or

(D) It fails to comply with any rule or regulation prescribed by the Commissioner, with the approval of the Secretary, for the purpose of ascertaining the actual ownership of its outstanding stock.[10]

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[8] Revenue Act of 1936, Secs. 13 and 27.

[9] Id., Sec. 48 (e).

[10] The record of the hearing before the Senate Finance Committee preceding the enactment of the Revenue Act of 1936 does not disclose the genesis of this concept of "mutual investment company." However, a statement of Paul C. Cabot, as president of State Street Investment Corporation, and Merrill Griswold, as chairman of the board of Massachusetts Investors Trust, in support of the foregoing provisions, was introduced into the record by Senator David I. Walsh, of Massachusetts, reading in part as follows (Hearings before the Senate Committee on Finance, on an Act to Provide Revenue, Equalize Taxation, and for other Purposes, 74th Congress, 2d Sess., at 799–800):

> The two Boston mutual investment trusts signing this document merely constitute a conduit through which 40,000 persons residing in practically every State in the Union have made investments in stocks of about 130 different corporations. Over a period from 1924 to date these 40,000 people have invested about $120,000,000 in these funds, the average investment being about $3,000 apiece. This $120,000,000 as of March 31 was worth approximately $140,000,000. Most of the shareholders are persons of moderate means, either not in the surtax brackets or else in the lower tier of such brackets, who do not have equal facilities with the wealthy to obtain expert supervision and diversity in their investments. It is in order to obtain these benefits that they have availed themselves of these funds which guarantee to redeem all or any part of their shares at any time at a price approximately equal to the liquidating value per share, which price, of course, varies from day to day with changing market conditions.

At the public hearing before this Commission Mr. Griswold intimated that investment companies like Massachusetts Investors Trust were commonly called "mutual investment companies," but he was unable to state the origin of the term. (Public Examination,

An identical provision defining "mutual investment companies" was contained in the Revenue Act of 1938,[11] and the tax preference accorded such companies remained substantially the same.[12]

2. FORM OF ORGANIZATION

Open-end management investment trusts and investment companies have usually taken one of two forms, either that of a business trust or that of a corporation. Prior to 1930, the trust form of organization for open-end investment companies was more popular than the corporate type, but thereafter the number adopting the corporate form increased until at the end of 1936 there were 31 open-end investment companies proper organized as corporations to 8 organized as trusts. However, closed-end investment companies favored the corporate form of organization throughout the period and at the end of 1936 there were 101 closed-end investment companies proper organized as corporations to 12 adopting other forms.[13] The relative popularity of the trust form in the open-end field was probably due, at least in part, to the legal and structural complications of continuous redemptions by corporations.

Massachusetts Investors Trust, Incorporated Investors, and State Street Investment Corporation, the three largest open-end investment companies at the end of 1936, all had their principal places of business in Boston, Massachusetts, and all of them originally denied voting privileges to certificate holders. Massachusetts Investors Trust possessed managing trustees who held office during the life of the trust and who filled vacancies in their own membership, Incorporated Investors established a voting trust, and nonvoting certificates were issued to investors, while State Street Investment Corporation issued a small number of voting but irredeemable shares to the sponsors while only nonvoting but redeemable stock was sold to investors.[14] However, on June 22, 1933, the management stock (Class A) of State Street Investment Corporation was retired and the Class B stock in the hands of the public received voting privileges.

3. SPONSORSHIP

Two types of sponsorship predominated in the organization and operation of open-end investment companies, namely, the sponsors trained and interested in the distribution of securities and the sponsors

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Massachusetts Investors Trust, at 2454–5.) A possible reason for its use was suggested in the testimony of O. M. W. Sprague, a member of the Advisory Board of Massachusetts Investors Trust, who recognized certain advantages in the use of the term, as follows (id., at 2454):

> Q. It may be a very nice word to use in connection with sales, too, Mr. Sprague; it has that conservative ring.
> A. Yes.

[11] Revenue Act of 1938, Sec. 361.

[12] Id., Sec. 362.

[13] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II, Table 26. In September 1939 there were 78 open-end investment companies registered with this Commission under the Securities Act of 1933. Of this number, 55 were organized as corporations while 23 were organized as Massachusetts or business trusts.

[14] Replies to the Commission's questionnaire for Massachusetts Investors Trust, Pt. I, Incorporated Investors, Pt. I, and State Street Investment Corporation, Pt. V.

specializing as investment counsel. The majority of open-end investment companies, and particularly the larger companies, were sponsored at some period of their existence by security salesmen or firms connected with the distribution of securities.[15] This was a type of sponsorship essentially quite different from that of the majority of closed-end management investment companies, which were formed by investment bankers and brokers. The latter distributed substantial blocks of securities within relatively short periods of time on the basis of their prestige and to an established clientele. Sponsors of open-end investment companies specializing in distribution required no prestige, no clientele, and conducted continuous sales efforts with no definite ideas as to what the ultimate sizes of the investment companies would be. As a large and wide distribution of securities was essential if these open-end investment companies were to survive, they constituted an ideal vehicle to provide profits to such sponsors in the form of definite loading charges added to the prices of the shares sold. Because of the emphasis upon selling in this group the turnover of stockholders was accelerated and management tended to be limited to investment in the well known common stocks.[16]

The remaining open-end investment companies were organized primarily by fund managers and investment counsel, frequently as an adjunct to their established investment counsel business, for the declared purpose of managing common-stock funds more economically, of taking care of small investors, or for other similiar reasons. In the case of these companies the chief source of profit was from management fees. Distribution of the securities of these companies was relatively inactive and within limited areas, as their shares were principally sold to the clients of the investment counsel firm or to similar investors.[17] Because of the emphasis upon management rather than upon selling and the more intimate relationship between stockholders and sponsors, open-end companies sponsored by investment counsel services tended to be more unrestricted by charter limitations in their investment activities; had a smaller investor turnover than other type sponsored companies;[18] and their average loading charges were lower.[19] Inasmuch as these investment counsel sponsored companies were in the minority and represented only about 22% of the assets of

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[15] If the whole group of open-end companies be considered, 23 of 39 companies were at some time sponsored by persons clearly connected with the distribution of securities, and these 23 companies represented $272,400,000 of assets at the end of 1935 or 78.7% of the $346,300,000 of assets of the whole group. In addition, 4 companies were sponsored by persons who apparently had some connection with distribution. These companies represented $6,100,000 of assets or 1.8% of the total.

[16] For further details see infra, pp. 809 and 820–23.

[17] State Street Investment Corporation, which definitely is the largest example of this classification, engaged, however, in active distribution from November 15, 1933 to June 26, 1935, and will therefore be discussed in the first group.

[18] However, no marked differences exist between open-end investment companies sponsored by investment counsel and the other open-end investment companies with respect to the ratio of redemptions to sales. (Pt. Two [House Doc. No. 70, 76th Cong.], Ch. III, pp. 241–4.)

[19] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 216–21. The loading charges of the open-end companies sponsored by investment counsel ranged between 1% and 2% while the companies sponsored by salesmen, investment bankers, and brokers had loading charges ranging between 5% and 10% with some concentration between 9% and 10% in 1935. (Ibid.)

the whole open-end group at the end of 1935,[20] the discussion will deal primarily with the open-end investment companies sponsored by persons interested in distribution.

4. SUMMARY STATISTICS

Although Massachusetts Investors Trust, Incorporated Investors, and State Street Investment Corporation, the three open-end investment companies which have at all times been and today are the outstanding units of the industry in point of size,[21] were formed in Boston, Massachusetts, prior to the end of 1927,[22] and Investment Trust Fund A was created in New York during the same period,[23] there was no substantial growth in number and amount of assets of open-end companies until after 1932. Thus, of $586,000,000 gross proceeds from the sale of the securities of open-end investment companies from 1927 through 1936, $360,000,000 thereof, or 61%, was paid in subsequent to 1932.[24] Only one open-end investment company reached a size in excess of $25,000,000 by the end of 1929 and its assets fell below this mark during succeeding years until 1933.[25] Thereafter the size of individual open-end companies increased steadily until at the end of 1936, five of the 39 open-end investment companies reported assets ranging from $25,000,000 to more than $125,000,000.[26] The concentration of assets in the large open-end investment companies was somewhat heavier than in the closed-end group.[27] Thus, the top 10% of the number of open-end investment companies possessed 40% of the group's total assets at the end of 1929 and 60% at the end of 1936, and the top 20% of the number possessed 60% of the total assets at the end of 1929 and 75% thereof at the end of 1936.[28] More than half of the 40 open-end investment companies reporting each sold less than $5,000,000 of their own issues and accounted for only about 7% of aggregate sales, while the six companies issuing more than $25,000,000 each of their own shares accounted for 67% of total sales.[29]

Because of the privilege accorded shareholders of open-end investment companies to redeem their shares at asset value, repurchases constituted an important aspect in the operation of such investment vehicles.[30] No exchange markets for such shares were ordinarily maintained, although distributors sometimes provided independent markets within the limits of the current offering and redemption prices.[31] From 1927 through 1936, the 40 open-end investment companies reporting to the Commission paid out $142,000,000 for the re-

[20] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II, Table 25.

[21] These 3 companies possessed combined assets of approximately $260,000,000 at December 31, 1936, or more than half of the estimated aggregate assets of all open-end investment companies at that date. (Id., Tables 2 and 6.)

[22] Pt. One (House Doc. No. 707, 75th Cong.), Ch. III, pp. 101–5.

[23] Id., pp. 108–10.

[24] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, Table 3.

[25] Id., Ch. II, Table 22.

[26] Ibid.

[27] Id., pp. 51–2.

[28] Ibid.

[29] Id., Ch. III, pp. 212–13, and Table 72.

[30] See infra, p. 806.

[31] See infra, p. 856.

purchase of their own shares, or about 25% of the $564,000,000 in sales of such shares during that period.[32] That these repurchases were somewhat concentrated is indicated by the fact that about half of the number of these companies redeemed less than 20% of their own issues and about a third of the number repurchased less than 10%. While periods when redemptions surpassed sales were observed, at no time was there any appreciable excess.[33]

B. Problems Inherent in the Open-End Concept

While the injection of the open-end concept into management investment companies has served to stabilize the market for the shares of that vehicle at their approximate asset values, this open-end feature has created problems of its own. The open-end aspects of investment companies present certain functional problems which tend to influence the management of their affairs.

1. THE POSSIBLE THREAT OF REDEMPTIONS AND LIQUIDATIONS

The open-end characteristics have not only affected the organic form of that investment vehicle,[34] but also have virtually compelled such investment companies to adopt capital structures with only a single class of stock.[35] As a consequence, leverage in the capital structure, so popular in the closed-end investment company field, has been practically nonexistent in open-end investment companies.

The obligation of open-end investment companies to redeem their shares at or about asset value upon demand for the most part confined portfolio investments to well-known and readily marketable common stocks.[36] Such portfolios not only fulfilled the requirements for liquidity but also apparently were of definite aid in selling shares. This investment policy was made necessary by reason of the constant possibility of substantial redemptions by shareholders during relatively short periods of time. The quarterly figures for redemptions in relation to gross sales [37] indicate that in two quarters (the fourth quarter of 1930 and the third quarter of 1931) the flow of securities back to open-end investment companies in the form of redemptions exceeded the sale of the security issues of such companies. Incorporated Investors illustrates the problems which redemptions may present when they are greatly in excess of sales. In the fourth quarter of 1929 the excess of redemptions over sales by this investment company was close to $2,000,000. In the third and fourth quarters of 1930 the excess was $117,000 and $1,256,000 and in the third quarter of 1931 the excess was $1,291,000.[38] Although this rapid flow back of its security

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[32] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 241–4.

[33] Ibid.

[34] See supra, p. 800.

[35] One exception is Affiliated Fund. Inc., discussed infra. A more detailed discussion of senior securities in the capital structure of open-end companies and the possible effect upon senior securities from redemptions by holders of junior securities is contained infra.

[36] For more detailed discussion of effect of continuous sales campaigns upon investment policy and portfolios of open-end companies see infra, pp. 820–23.

[37] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, Table 81.

[38] Op. cit. supra, note 5, Pt. IX (Table 44).

issues did not create an acute problem for the company, it did necessitate bank borrowing. The potential recurrence of this situation makes either bank borrowings or the liquidation of portfolio securities of the company a constant possibility.

O. M. W. Sprague, a member of the advisory board of Massachusetts Investors Trust, admitted that considerations of this character may have an effect upon management policies.[39]

Q. My point is wholly this: That it seems to me that this trust, of the size it is now, and no one knows how big it is going to get, that a forced liquidation in the event of a major decline tends to concentrate upon the securities of an open-end trust, because the fellow who has investment in that type of trust and in other securities does not suffer the discount in the open-end trust that he may suffer in other securities. So he is going to liquidate the open-end securities, first, to reduce his losses. I should like to have your opinion on that aspect,—how the whole force of liquidation tends to concentrate on the open-end trust—and ask if that is not a weakness in the trust economically?

A. I should only think it was a weakness to the extent that it might induce us to confine ourselves a bit more, and to a little greater extent, to readily marketable securities than would otherwise be the case. That is insofar as we hold some of the large and well known companies we are able to sell them, and we have a certain amount of cash, and a borrowing power.

A large volume of redemptions by open-end investment company shareholders concentrated in a short period of time may aggravate the risks of loss to the remaining shareholders in the company. To raise the cash to meet these demands for redemption, it may become necessary to liquidate the most salable portfolio issues—issues with generally best markets—leaving the less liquid securities in the portfolio for the remaining shareholders. If the funds necessary to meet the redemption demands are raised by borrowing, the result is an acceleration of the rate of decline of the shareholders' equity through leverage. Fortunately, up to the end of 1939 open-end investment companies had not experienced the tremendous liquidations concentrated within brief periods of time comparable to "runs" on banks.[40]

However, the constant threat of possible liquidation of open-end investment companies by reason of their redemption provisions does exist and results in continuous sales programs in order to maintain their assets by offsetting redemptions with new sales. The effect of repurchases in compelling sales can be illustrated by the experience of the two largest open-end investment companies from October 1929 to December 1932, a period of heavy liquidation in the securities markets. At the end of September 1929 Massachusetts Investors Trust had 298,687 shares outstanding. From that date until December 31, 1932, it was called upon to repurchase 235,016 of its outstanding shares. Thus, if no new sales of shares had been effected, the amount of assets of the company would have been reduced by almost 80% by virtue of these redemptions alone.[41] However, at the close of 1932 this company had outstanding 951,752 shares, primarily accounted for by the sale of new shares in its continuous selling program.[42] Similarly, In-

[39] Public Examination, Massachusetts Investors Trust, at 2435–6.

[40] However, see the Equity companies of Incorporated Investors, infra, pp. 841–4.

[41] Reply to the Commission's questionnaire for Massachusetts Investors Trust, Pt. IX.

[42] Ibid. During 1930, 1931, and 1932 stock dividends and distributions by this company accounted for the issuance of 27,478 shares. (Id., Pt. II.)

corporated Investors had 889,801 shares outstanding on September 30, 1929, and bought back 785,898 shares, or 88%, between that date and the end of 1932.[43] Yet, as of December 31, 1932, there were outstanding 1,158,030 of this company's shares, also substantially accounted for by a continuous selling campaign.[44] It is clear that if a decided selling effort had not been made in both instances and such repurchases had occurred, the assets of these investment companies would have been seriously diminished.

In certain cases, open-end investment companies stopped selling their shares where they attained a size deemed adequate by their manager. Yet the redemption provisions of those companies are still operative, and, although repurchases may be made in only small amounts, eventually they will liquidate if selling is not resumed. During the period from July 29, 1924, the date of the organization, to November 15, 1932, State Street Investment Corporation did not actively sell its shares, although some shares were sold privately at their asset values. Its growth during that period resulted from the demands of purchasers seeking to buy the stock, as distinguished from sales through the use of selling organizations.[45] During the July 29, 1924, through September 30, 1932, period, 195,324 shares (or 36.3% of the total sold during the years 1924–1935) were purchased by investors at their asset values, for net proceeds to the Corporation of $20,872,000 (or 49.2% of the total net proceeds received during the years 1924–1935).[46]

The effect of the continued undertaking by State Street Investment Corporation to repurchase its stock at liquidating value during the depression period, September 30, 1929, to September 30, 1932, resulted in a net reduction of shares outstanding by 17.2%.[47] During the same period its net assets, at market value, declined from $29,099,000 to $7,833,000, or a shrinkage of 73% caused by the redemption of its stock coupled with the realized and unrealized depreciation of its assets.[48] Because of this decline in the investment company's assets, the policy of active distribution was adopted.[49]

The second period of the Corporation's growth, November 15, 1932, to December 31, 1935,[50] was a period of active and continuous selling. During the September 30, 1932, through December 31, 1935, period, 342,654 new shares (or 63.7% of the total sold during 1924–1935) were purchased by investors, not at their asset value as in the earlier period, but at asset value plus a loading charge of 6% of the offering price.[51] The net proceeds of $21,584,000 received by the investment company (or 50.8% of the total net proceeds received during the 1924–1935

[43] Op. cit. supra, note 5, Pt. IX.

[44] Ibid. Stock dividends by Incorporated Investors during the years 1930, 1931, and 1932 accounted for the issuance of 135,212 shares. (Id., Pt. II.) Also, a stock dividend of 2½% in October 1929 (*Poor's Governments, Municipals, etc.*, 1930, p. 1079) caused the issuance of approximately 22,250 shares.

[45] Public Examination, State Street Investment Corporation, at 2708, 2717–18.

[46] Reply to the Commission's questionnaire for State Street Investment Corporation, Pts. II and IX.

[47] Id., Pt. IX (Table 43).

[48] Id., Pt. II.

[49] Op. cit. supra, note 45, at 2722–4.

[50] Op. cit. supra, note 46, Pt. IX.

[51] Ibid.

period) were approximately equal to the net proceeds from the sale of shares during the first period. Although the distribution contracts were terminated as of June 22, 1935, active distribution continued to the end of that year, when such distribution was discontinued.

2. THE COST TO INVESTOR OF DISTRIBUTION

The shares of 40 open-end investment companies outstanding as of December 31, 1936, represented an original investment during the period from 1927 through 1936 of about $422,000,000.[52] Since a total of $564,000,000 was paid into these companies during the period, it might be supposed that the $142,000,000, or 25% of the total paid in by investors, returned to shareholders through repurchases represented the extent of the turnover of investors in this type of investment company. However, other factors must be considered which tend to alter this turnover ratio considerably.

The principal distributor of each of the larger open-end investment companies during the periods of active distribution purchased shares from dealers and the public and resold these shares immediately, without the investment companies being involved in the transactions. Data upon the volume of such trading are available for several of the larger companies and it is estimated therefrom that about $50,-000,000 of open-end company shares were so purchased and resold. In addition there is the whole field of trading in shares of open-end investment companies by dealers and others. Although no definite data are available, it is known, however, that there were active over-the-counter markets for these shares and that there was considerable activity by dealers in switching customers from one open-end investment company to another.[53] It is estimated that such dealers and others bought and sold, without dealing with the principal distributor or the investment company, such shares equal to the total sales reported by the investment companies, or a volume of about $564,000,000.

Based upon the foregoing estimates it would appear that for each dollar invested in open-end investment companies as of the end of 1936 it was necessary to market almost three dollars' worth of shares. Hugh Bullock considered even a greater rate of turnover to be "a normal turnover" when he testified concerning three of the open-end investment companies sponsored by Calvin Bullock.[54] He further testified:[55]

Q. Well, wouldn't it indicate for every $400 that the public put in that only $100 remained as a permanent investment?

A. The figures would indicate that, but I must point this out: A very real factor in considering this picture from the angle that you are now standing at, is this rather unique self-liquidating feature in our various trusts, as against the customary closed picture in some of these larger management trusts.

Q. Yes. Of course you mean in your fixed trusts, too?

A. I mean that only one company that we have today out of our ten, fails to have a self-liquidating feature, and I attribute to the major factor making

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[52] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 241–4.

[53] See infra, pp. 855 et seq.

[54] Public Examination, Calvin Bullock Trusts, at 4196–7.

[55] Ibid.

for that turnover that you cite, the self-liquidating feature that has been so common in the Bullock trusts as a group.

* * * * * * *

Q. But that is the characteristic of the open-end trust, isn't it?—The constant turnover?

A. Yes, it is apt to be.

Closed-end management investment companies usually make single or isolated offerings of their shares and changes in ownership thereafter require the payment of only the brokerage commissions.[56] Such turnover in the shares of open-end investment companies, however, involves a repurchase and resale, either through the investment companies or the intermediate markets of the dealers or distributors, and the cost to the new shareholder includes the addition of another selling commission or load.[57] Thus the cost of maintaining as outstanding a share of an open-end investment company increases each time that it is reacquired and reissued. If 7% be assumed to be the average loading charge upon the foregoing estimated total sales of shares by open-end investment companies and upon the distributors' markets, and 5% the loading charge upon such transactions completed in the dealers' markets, investors paid more than $70,000,000 to invest, sell and reinvest their money in the security issues of open-end investment companies in order to maintain an investment of $420,000,000. In other words, it is estimated that it cost about $16.70 to retain $100 in open-end investment companies for investment in portfolio securities over a 10-year period. This compares with the less than 1% per annum paid for operating expenses, during the same period.[58]

Some justification may exist for relatively higher selling commissions upon the shares of open-end investment companies during the earlier stages of their development, because of the difficulty of selling the shares of growing and unknown funds in competition with established vehicles. However, the three largest open-end investment companies (Massachusetts Investors Trust, Incorporated Investors, and State Street Investment Corporation) have had loading charges during their periods of active distribution generally lower than other open-end investment companies maintaining active selling organizations.[59]

Massachusetts Investors Trust, the largest open-end investment company in the field,[60] with assets at the end of 1936 of $128,107,000,[61] did not reduce its loading charge much below the usual level. In January

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[56] It should be noted, however, that in connection with the sales of the closed-end company shares, these securities may sell in the market at a discount (at a price below asset value), or at asset value (which is substantially always the "market" price of open-end company shares), or at a premium (at a price above asset value).

[57] In addition there was sometimes charged a redemption fee which increased the cost to the public of maintaining individual funds. (See infra, p. 819.)

[58] Based upon the analysis of operating expenses contained in Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II, Table 39. It should be borne in mind that the open-end investment company industry received its greatest impetus in the last half of the 10-year period under discussion, so that for such years the turnover, and consequently the relative cost of maintaining the funds, was probably considerably higher.

[59] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 216–21.

[60] Id., Ch. II, Table 6.

[61] Derived from supplementary information supplied the Commission for Massachusetts Investors Trust.

1930 this investment trust increased its selling commission from 6% to 7% of the offering price; on February 1, 1932, it again increased the load to 8¼% of the offering price; and after May 20, 1933, it maintained the load at 8% of the offering price.[62] Merrill Griswold, chairman and trustee of Massachusetts Investors Trust, testified in this regard as follows:[63]

Q. What was the reason for the increase in the load to 1930 and 1932?

A. The reason was that in those days the stock naturally did not sell as high as it does now, and the dealer had to sell more shares to make himself the commission that he does now. It was in the height of the depression, and it was relatively more difficult to sell securities. We had to meet competition. Most other trusts in the country charged about 8 percent or more. A good many of them charged more. If we at that time reduced our load to 5¾, I don't think anybody would have sold any of our shares to anybody. They could get a better load from someone else.

The commissions paid were high enough to induce sales sufficient to constitute this the period during which the greatest expansion of this investment company took place.[64] The importance of this selling load in comparison with operating costs was revealed by the further testimony of Mr. Griswold:[65]

Q. The total load, or the selling cost, of selling these shares to the public, which was deductible from that figure, was $5,900,000. Is that correct?

A. Yes.

Q. And the total operating expenses, including taxes, over the same period were $1,500,000? That is approximately correct?

A. I assume that is correct.

Q. So that it cost about four and one-half times to get into this as you felt it necessary to manage it?

A. It costs anywhere from 8 to 6 percent to get into this trust, and our operating expenses averaged between 10 and 14 percent per annum. They are now running at the rate of 10.[66] I assume your figures are correct.

On May 18, 1936, the loading charge was reduced to 5¾% of the offering price,[67] in the hope that the prestige of the fund would help to carry sales. Mr. Griswold indicated that this reduction was something of an experiment:[68]

Q. So when you reduce the compensation to the salesman, he does not push the stock quite so hard. Would you say that?

A. I would say that for the time being, but I believe that in future times the trust will sell better with the lower load. It will appeal to a higher type of clientele.

Q. You have another trust whose securities were mentioned earlier, whose securities are distributed by Massachusetts Distributors, Incorporated.

A. Yes; Supervised Shares.

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[62] Op. cit. supra, note 41, Pt. V (Item 42–d–V).
[63] Public Examination, Massachusetts Investors Trust, at 2409.
[64] Op. cit. supra, note 41, Pt. IX (Table 44).
[65] Op. cit. supra, note 63, at 2303–4.
[66] Computing operating expenses as a percent of ordinary income. (Id., at 2301.)
[67] Op. cit. supra, note 61.
[68] Op. cit. supra, note 63, at 2333–4.

Q. What is the load on its shares?

A. 8 percent.

Q. Have you reduced that?

A. No, sir.

Q. It can be fairly assumed if you do not reduce that, as you have the M. I. T., the sales organization is going to plug the sale of those shares right along, because there is bigger commission. Won't you have to assume that?

A. We may reduce that some day. It was an experiment with the Massachusetts Investors Trust to see whether we could sell it at a more reasonable price to the public.

However, on January 16, 1939, the selling commission on the shares of Massachusetts Investors Trust was raised to 7% of the offering price.[69]

In addition to the published loading charges there are, in connection with sale of shares or operation of open-end investment companies, hidden loads,[70] management fees, operating expenses, and taxes [71] to be charged to the investment funds.[72]

C. The Domination of Distribution

It will be recalled that the open-end investment company experienced its greatest impetus after 1932, when the security markets were discounting the shares of closed-end investment companies.[73] The open-end investment company was turned to by professional distributors as a new model of investment vehicle which could combine features of current sales appeal, in the form of limited management discretion and the right of shareholders to redeem their investments at asset values, with the opportunities for profit from the continuous and unlimited distribution of shares.[74] In short, the open-end investment company may attribute its expansion largely to the fact that it was designed to overcome buyer resistance and could be merchandised through widespread retail channels.

Even if the management is completely divorced from the distribution function, the managers and the distributors may still have a common interest in increasing the size of the fund, for the greater the sales the greater the sales commission, and the greater the size of the fund the greater the management compensation. For example, during the period from September 30, 1929, to September 30, 1932, State Street Investment Corporation's net assets declined 73.4% due to decline in market value of the portfolio and sums expended for redemptions and the number of shares outstanding was reduced by 17.2%.[75] This shrinkage in assets resulted in a corresponding decrease in management

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[69] Op. cit. supra, note 61.

[70] See infra, pp. 813.

[71] The Federal income tax burdens have been somewhat alleviated for open-end investment companies qualifying as "mutual" investment companies under the Revenue Acts of 1936 and 1938. (See supra, pp. 801–2.)

[72] For performance records of open-end management investment companies see Pt. Two (House Doc. No. 70, 76th Cong.), Ch. VI, pp. 480–8, and Appendix J, pp. 876–900.

[73] See Ch. 1 of this part of the report, pp. 26–31.

[74] O. M. W. Sprague, a member of the Advisory Board of Massachusetts Investors Trust, expressed the opinion that the size of that investment trust should not rest within the determination of its principal distributor. (Op. cit. supra, note 63, at 2417.)

[75] See supra, p. 808.

compensation, exclusive of the fact that it was computed at 1% annually of net assets until January 1, 1932, when it was reduced to ½ of 1%.[76] Because of the funds expended for redemptions, reduced rate of income, and decline in market value of assets, it was felt that the fund would have to be enlarged in order to support the research work that was considered essential.[77] A sales campaign was therefore instituted which netted the investment company $21,584,000.[78]

1. MULTIPLE AND HIDDEN LOADS

The basic sources of compensation received by the distributors and dealers from the sale of the shares of open-end investment companies is the published sales commission or "loading charge." This charge is usually expressed as a fixed percentage of the net asset value per share and represents the disclosed premium over the basic price which the investor pays to become a stockholder or participant in the open-end company. The load is designed to cover the distribution costs of the principal distributor and dealer. Similarly, redemption fees charged upon redemption of shares are used by some open-end investment companies to cover the costs of repurchasing shares.

The open-end distribution system permits the inclusion of certain multiple and hidden profits which do not prevail in the closed-end companies. Thus the various additions and adjustments made in the computation of the selling commission serve to enlarge the distribution profits beyond the apparent implications of the published load while the recurrence of these charges each time the shares change ownership multiplies such profits. The effect of such practices upon the investor is to shrink his investment each time he is persuaded to alter his position.[79]

a. Basic Price Calculation

The starting point in the determination of the distribution profits from open-end investment company shares, is the per share liquidating or net asset value. The theory is that each new share will be sold by the investment company for an amount equal to the asset or liquidating value of each share already outstanding, and that each share upon redemption will entitle the holder to receive a proportionate part of the total assets. Thus, the calculation of this per share interest is a basic part of the distribution and repurchase of the shares of open-end investment companies. All open-end investment companies have been similar in the respect that any calculation of offering and redemption prices starts with the net asset value per share, which in turn is based upon the market value or estimated value of underlying portfolio securities of the company. The detailed method of computing asset value is usually set forth in the charter or trust indenture.

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[76] Op. cit. supra, note 46, Pt. I (Exhibit 5).

[77] Op. cit. supra, note 45, at 2722–4.

[78] See supra, p. 808.

[79] Dealers were often reluctant permanently to place their customers into an investment fund when they might obtain recurring commissions from the constant turnover usual in such accounts.

The details of the calculation of sales and redemption prices as of December 31, 1935, are summarized in Table 6, which illustrates some of the variations in the methods of calculating net asset value in determining the selling price, and in Table 7, which shows the factors taken into consideration in calculating the net asset value preliminary to setting a redemption price.[80]

TABLE 6.—*Methods of calculating liquidating value for purpose of sale by 38 open-end management investment companies*

	Number of companies	
I		
Valuation of portfolio securities—Prices of securities traded on an exchange are based on—		
Last sale price	36	
Closing bid price	2	
Prices of securities not traded on an exchange are based on—		
Closing bid price	28	
Average of closing bid and asked prices	10	
Valuation made on prices as of—		
Day of sale of trust securities	7	
Previous day	23	
Other	8	
Prices are adjusted—		
To the nearest dollar	3	
Yes (not specified)	1	
No	34	
II	Yes	No
To value of funds as computed above, are added—		
Full-lot brokerage	4	34
Odd-lot brokerage	0	38
Odd-lot premiums	1	37
Administrative fees	0	38
Fees of custodians or trustees	0	38
Other items	7	31
III		
From total assets are deducted book liabilities and—		
Estimated taxes on unrealized appreciation	24	14
Other charges	5	33
IV		
The resulting per share figure is adjusted to—		
Nearest cent	24	
Next highest cent	8	
Nearest 5 cents	1	
Nearest eighth	1	
Nearest quarter	1	
Not adjusted	3	

[80] Derived from the replies to the Commission's questionnaire for 38 open-end investment companies, Pt. IX.

TABLE 7.—*Methods of calculating liquidating value for purpose of redemption by 38 open-end management investment companies*

	Number of companies	
I		
Valuation of portfolio securities—Prices of securities traded on an exchange are based on—		
Last sale price	35	
Closing bid price	3	
Prices of securities not traded on an exchange are based on—		
Closing bid price	28	
Average of closing bid and asked prices	10	
Valuation made on prices as of—		
Day of tender for repurchase	13	
Next day following	13	
Other	12	
Prices are adjusted—		
To the nearest dollar	3	
Yes (not specified)	1	
No	34	
II	Yes	No
From value of fund as computed above, are deducted—		
Full-lot brokerage	7	31
Odd-lot premiums	3	35
Administrative fees	16	22
Estimated fees of custodians or trustees	10	28
Taxes on unrealized appreciation	25	13
Other charges and liabilities	8	30
III		
A further deduction for a redemption fee—		
Was provided in charter or indenture	20	18
Was charged at Dec. 31, 1935	17	21
and payable to sponsor	8	
and payable to company	9	
IV		
The resulting per share figure is adjusted to—		
Nearest cent	17	
Next lower cent	3	
Next higher cent	2	
Nearest quarter	1	
Not adjusted	15	

This net asset value is the amount received by the investment company from sales of its own shares or paid out by the company upon redemption in liquidation of its shares. The fees and loading charges, which are superimposed on this asset value as a part of the retail selling price, usually go to the principal distributor.

Small charges were deducted by nine open-end investment companies in calculating liquidating value for redemption purposes which were not deducted in the calculation of liquidating value for selling

purposes.[81] In such cases the retiring shareholders usually contributed unwittingly to the benefit of the remaining shareholders.

An interesting factor in the determination of the basic price of the shares of open-end investment companies is the return of capital received by new stockholders as dividends. It has been the practice for many open-end investment companies to calculate the selling price of each new share, so that it will include a sum equal to the per share amount segregated by the investment company for the payment of the next dividend on the shares already outstanding.[82] This portion of the proceeds realized by these companies on the sale of new shares is distributed on the next dividend date. Thus, these companies have constantly been paying out as dividends on newly issued shares a portion of the proceeds which they received on the sale of such shares.

Although this method of equalizing dividend payments protects the old stockholders of the investment company, it was not always disclosed to the new stockholder that he was receiving in fact a return of capital in the form of dividends. For example, the reports of Incorporated Investors for the years 1930 to 1932 showed no equalization credits as separate items, nor was there a disclosure of this practice in the sales literature of that investment company.[83] William A. Parker, president of Incorporated Investors, thought that a statement concerning this return of capital would only confuse the investor:[84]

Q. Therefore, the strictly correct title for this would be "Principal and income that has not failed," because these lines representing income also include in part a certain return of principal?

A. No, I would never have put that into any sales literature, circular, or quarterly report, because I don't believe any of my stockholders would understand it.

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[81] The companies for which this variation was found are listed below together with the amount by which net asset value per share for purposes of sale exceeded net asset value per share for purposes of redemption on December 31, 1935, as derived from the price calculations supplied in the replies to the Commission's questionnaire, Part IX (Tables 42, 43), for the respective investment companies:

Name of company	Cents per unit	Percent of net asset value per share for purposes of sale
Affiliated Fund, Inc	1.20	0.7
American Business Shares, Inc	0.55	0.5
Bullock Fund, Ltd	1.47	0.1
Dividend Shares, Inc	0.19	0.1
Equity Fund, Inc	5.00	1.3
Fundamental Investors, Inc	4.90	1.9
General Capital Corporation	25.00	0.7
Investors Fund of America, Inc	1.03	1.0
Nationwide Securities Co. (voting)	0.17	0.1

[82] Dividends paid by open-end investment companies were in excess of ordinary net income in every year but 1928 and 1929 during the 1927–36 period. (Pt. Two [House Doc. No. 70, 76th Con.] Ch. II, pp. 83–5.)

[83] Op. cit. supra, note 5, Pt. I.

[84] Public Examination, Incorporated Investors, at 2587.

Q. They would not understand?

A. And further than that, it would have given them a false idea of what had happened.

Q. Isn't that all the more reason to put it in?

* * * * * * *

A. Were you in the business, you wouldn't say that. It is not practical to educate your stockholders to the point that they would understand that.

The inclusion of such items in the determinations of the base price serves to increase the commissions payable in the sale of such securities. While such profits may seem trivial individually, they have constituted substantial sums in the aggregate.[85]

b. The Published Load

The public, in making investments in open-end investment companies, has paid loading charges purporting to constitute the costs of distribution as well as the entire profits of the distributors. For these purposes the loading charge may be characterized as the known premium which the investor must pay to participate in the investment company.

This published loading charge has been variously stated either as a specified dollar amount,[86] as a percentage of the net asset value of the share or as a percentage of the offering price of the share. The statement of the loading charge as a percentage of the offering price is apparently the method most used and results in a smaller percentage figure than when expressed as a percentage of the net asset value.

The group of open-end investment companies sponsored by investment counsel and similar firms have sold their shares with low loading charges, generally around 1% and 2% of the asset value per share.[87] Apparently these sponsors have been primarily interested in income from management fees and did not support extensive distribution systems.[88] The dominant group of companies, those sponsored by salesmen and others connected with the distribution of securities, has had loading charges of between 6% and 10% of proceeds with a definite concentration in 1935 between 9% and 9.99%.[89] In the early 1930's the selling loads were raised, presumably to increase sales and to provide a sustained dollar compensation upon the depreciated shares. Since 1933 there has been a slight movement towards lower loading charges.[90] Table 8, which lists the selling commissions charged upon the shares of 39 open-end investment companies during the 1927–1935 period, indicates these trends.

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[85] See discussion of T. I. S. Management Corporation, infra, pp. 847 et seq.

[86] The shares of Incorporated Investors for example were first sold with a loading charge of $6 per share regardless of asset value. (Op. cit. supra, note 5, Pt. I [Exhibit 3].)

[87] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 214–5, and Table 72.

[88] See supra, p. 803.

[89] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 216–20.

[90] See supra, pp. 809–11.

TABLE 8.—*Loading charges on open-end investment company shares at year-ends, 1927–35* [a]

[Stated as percentages of net asset values]

Name of investment company	1927	1928	1929	1930	1931	1932	1933	1934	1935
A. THREE LARGEST COMPANIES									
Incorporated Investors	6.0	5.0	5.0	5.8	6.95	6.95	7.5	7.5	7.5
Massachusetts Investors Trust	6.0	6.4	6.4	7.5	7.5	9.0	8.7	8.7	8.7
State Street Investment Corp	------	------	------	------	------	6.4	6.4	6.4	[b] 6.4
B. GROUP SPONSORED BY INVESTMENT COUNSEL									
Eaton & Howard Mgt. Fund A-1	------	------	------	------	------	3.0	5.0	5.0	6.4
Eaton & Howard Mgt. Fund B	------	------	2.0	2.0	3.0	3.0	5.0	5.0	6.4
Eaton & Howard Mgt. Fund F	------	------	------	------	------	3.0	5.0	5.0	6.4
First Investment Counsel Corp	------	------	[c] 1.0	[c] 1.0	[c] 1.0	[c] 1.0	[c] 1.0	[c] 1.0	[c] 1.0
Investment Trust Fund A	1.0	1.0	1.0	1.0	------	------	------	------	[b] 1.0
Investment Trust Fund B	1.0	1.0	1.0	1.0	1.0	1.0	------	------	[b] 1.0
Investors Fund C Inc	------	------	------	------	1.0	1.0	1.0	1.0	1.0
Loomis Sayles Second Fund, Inc	------	------	------	------	------	------	------	0	0
R. B. C. Fund, Inc	------	------	0	0	0	0	0	0	0
Third Investment Counsel Corp	------	------	[c] 1.0	[c] 1.0	[c] 1.0	[c] 1.0	[c] 1.0	[c] 1.0	[c] 1.0
C. OTHERS									
Administered Fund Second, Inc	------	------	------	------	------	------	------	6.4	6.4
Affiliated Fund, Inc	------	------	------	------	------	------	------	9.3	9.3
American Business Shares, Inc	------	------	------	------	------	9.5	9.5	9.5	9.5
American General Equities, Inc	------	------	------	------	11.1	11.1	10.8	9.75	9.75
Bullock Fund, Ltd. (cons.)	------	------	------	------	------	8.75	8.75	7.3	7.3
Canadian Investment Fund, Ltd	------	------	------	------	------	9.5	9.5	9.5	9.5
Century Shares Trust	------	4.0	4.0	4.0	6.25	8.5	8.5	7.5	7.5
Commonwealth Investment Co	------	------	------	------	------	7.0	7.0	7.0	7.0
Dividend Shares, Inc	------	------	------	------	------	9.5	9.5	9.5	9.5
Equity Fund	------	------	------	------	------	5.0	7.0	7.0	7.0
Fidelity Fund, Inc	------	------	------	------	7.75	7.75	7.75	7.75	7.75
Fundamental Investors, Inc	------	------	------	------	------	------	8.5	8.5	8.5
General Capital Corp	------	------	------	------	------	------	------	------	6.4
Group Securities, Inc	------	------	------	------	------	------	------	9.6	9.6
Income Foundation Fund, Inc	------	------	------	------	------	------	------	9.89	9.89
Investors Fund of America, Inc	------	------	------	------	------	------	------	------	9.25
Maryland Fund, Inc, The	------	------	------	------	------	------	------	9.5	9.5
Mutual Investment Fund	------	------	------	------	------	------	9.5	9.3	9.3
Nation-Wide Securities Co	------	------	------	------	------	9.5	9.5	9.5	9.5
Premier Shares, Inc	------	------	------	7.95	7.95	7.95	7.95	------	[b] 7.95
Quarterly Income Shares, Inc	------	------	------	------	------	------	9.5	9.5	[b] 9.5
Selected American Shares, Inc	------	------	------	------	------	------	9.0	9.0	9.0
Spencer Trask Fund, Inc	------	------	5.3	5.3	5.3	5.3	5.3	5.3	5.3
Supervised Shares, Inc	------	------	------	------	------	9.25	9.25	9.25	9.25
United Gold Equities of Canada, Ltd	------	------	------	------	------	------	17.65	17.65	17.65
Wellington Fund, Inc	------	------	10.0	10.0	10.0	9.9	9.9	8.7	8.7

[a] Compiled from the replies to the Commission's questionnaire for the individual companies.
[b] Last rate of loading charge used. No actual distribution at Dec. 31, 1935.
[c] Fee payable to investment company and not to the sponsor or principal distributor.

After the addition of the loading charge, fractional adjustments were made in most cases in the resulting offering prices. As at December 31, 1935, the adjustment was to the next higher cent in the case of 8 investment companies; the adjustment was to the nearest cent in

the case of 24 investment companies; one adjusted to the nearest 5¢; one to the nearest 1/4 point; and one to the nearest 1/8 point; while 3 made no adjustment. To the extent that these adjustments operated to the nearest cent or fraction they tended to balance out. However, the distributors of the investment companies which rounded off the prices of their shares to the next higher cent or fraction did make extra profits which could be quite sizable on a large volume of sales.[91]

c. Redemption Fees

In some open-end investment companies redemption commissions or fees were deducted in addition to the adjustments previously related in the computation of liquidating values for the purposes of redemptions. At the end of 1935, 17 of the 39 open-end investment companies charged a fee for redemption. Six of the eight investment companies which permitted the principal distributor to receive the redemption fee were in the group sponsored by managers of investment funds and the shares of all were sold with loading charges below the average for open-end investment companies.

Among the 15 largest open-end investment companies, there were only three which had redemption charges in effect as of December 31, 1935. State Street Investment Corporation permitted the deduction by the principal distributor, State Street Research & Management Corporation, of a fee of $1 for each share repurchased.[92] The basic reason for this charge was explained by Mr. Cabot, president of the investment corporation and the management corporation, as a form of insurance on the part of the management corporation, which had long-term commitments for salaries, etc.[93] A wholesale liquidation of the company's shares would mean an absence of income to pay such expenses while the receipt of $1 per share liquidating charge assured the management corporation of sufficient funds with which to carry on for some time.[94]

Spencer Trask Fund, Inc., redeemed its shares at 99% of the net asset value and retained the 1% liquidating fee, so that the benefit accrued to the remaining stockholders rather than to any distributor.[95] On the other hand, Investment Trust Fund A, one of the group of companies sponsored and distributed by investment counsel, permitted a fee of 1% of net asset value on the liquidation of any of its shares to be paid to the sponsor.[96]

Massachusetts Investors Trust has had the right to make such a charge but has not done so.[97] The original provisions of the trust agreement required this investment trust to redeem its shares at net asset value less $2 per share [98] and after February 19, 1929, it was required to redeem at net asset value less 1%.[99] After 1933, the trust

[91] See discussion of T. I. S. Management Corporation, infra, pp. 847 et seq.
[92] Op. cit. supra, note 46, Pt. IX.
[93] Derived from supplementary information supplied the Commission for State Street Investment Corporation.
[94] Ibid.
[95] Reply to the Commission's questionnaire for Spencer Trask Fund, Inc., Pt. IX.
[96] Reply to the Commission's questionnaire for Investment Trust Fund A, Pt. IX.
[97] Op. cit. supra, note 63, at 2413.
[98] Op. cit. supra, note 41, Pt. IX.
[99] Ibid.

agreement authorized the trustees to bid 100% of liquidating value, although requiring them to bid at least 99%.[100] At the end of 1935 the trustees, as a matter of practice, were still paying 100% of liquidating value.[101]

With respect to the use of redemption fees, H. Dudley Swim, vice president of National Investors Corporation, stated:[102]

> It seems only proper that the trust itself should receive any redemption fee. Furthermore, I incline to the opinion that a nominal redemption fee, say of 1%, to be retained by the trust, is proper and desirable in order to offset the expenses of the withdrawing stockholders' "round trip," which otherwise would be borne by the fund and hence the remaining investors.

Twenty-three open-end investment companies at December 31, 1935, provided for adjustments to round figures in determining the redemption value of the shares. Of these 23, 17 provided for adjustment to the nearest cent, three to the next lower cent, two to the next higher cent, and one to the nearest quarter. The profit from such adjustments was received by the party retaining the redemption fee.

Although it appears that redemption fees have not generally been employed to provide sponsor profits they have provided substantial additional compensation in some cases. Furthermore, redemption fees constitute sources of potential profits to the distributors which may yet be tapped, especially if any limitation should be imposed upon the selling commission.

2. POSSIBLE EFFECT OF DISTRIBUTION UPON INVESTMENT POLICIES

The effect of distribution exigencies on the affairs of open-end investment companies was particularly evident in their investment policies. The portfolios of open-end investment companies, especially that group sponsored by persons interested in distribution, were, for the most part, confined to common stocks.[103] These common stock investments were usually the well known or popular stocks listed and traded upon the larger stock exchanges.[104] This standard of investment was impelled not only by the necessity for liquidity of the portfolios by reason of the constant possibility of concentrated redemptions and liquidations[105] but also by the need for a portfolio possessing sales appeal to the prospective investor. Obviously, a portfolio consisting of obscure and unlisted securities would not attract investors in competition with a portfolio consisting of the better known listed issues, regardless of the intrinsic merits of the former. Similarly, an investor could not readily be induced to pay a substantial sales commission or load for the privilege of investing in a fund with a large cash position, regardless of the dictates of a conservative investment

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[100] Ibid.

[101] Op. cit. supra, note 63, at 2413.

[102] Derived from supplementary information supplied the Commission for National Investors Corporation (memorandum from H. Dudley Swim, April 14, 1938).

[103] Open-end investment companies invested a substantially greater proportion of their assets in common stocks than did closed-end management investment companies. (Pt. Two [House Doc. No. 70, 76th Cong.], Ch. II, pp. 73–5, and Ch. VIII, pp. 556–7.)

[104] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II, pp. 73–5.

[105] See supra, pp. 806 et seq.

position as required by the current market. For example, in the extreme hypothetical case of a company with a virtually all cash position, the investor would be asked to pay a 9% or 10% load or $110 for a share representing an interest in a fund which is all cash and the shares in which fund have an asset value of $100. The importance of such considerations was admitted by Edward G. Leffler, associated with the distribution of the shares of each of the three largest Boston open-end investment companies,[106] when he testified:[107]

Q. * * * If you have a cash position in your portfolio isn't it hard to sell the stock of the investment trust?

A. Yes, sir.

* * * * * * *

Q. When State Street had a large cash position?

A. Yes, sir.

* * * * * * *

Q. The tendency is to create a popular portfolio?

A. That might be the tendency.

Q. Another might be the tendency to style the portfolio in order to meet popular demand at the time?

A. Yes, sir.

Such considerations continue even after the principal sales campaign is terminated in order to prevent trade-outs. Ross Beason, principal sponsor of the Beason-Burris group of investment trusts and investment companies, stated:[108]

Unfortunately, during the selling period for an open-end fund where the liquidation clause is present it is necessary from a practical standpoint, or rather from a selling standpoint, to have the portfolio composed of companies more or less well known by name to the average investor, and consequently made up of a list found in similar competing funds. After the selling period is over, it is necessary to continue along much the same lines to avoid criticism and stop trade-out arguments of competitors.

Take the case of an investment fund with, say, $100,000,000 of assets. If we should run into another period such as we did in late 1929 and the management should appraise the future and get into a cash position, they would promptly be penalized for their efforts because the assets of this particular fund being in cash would show no shrinkage when the market fell and the shares of the fund would remain at a high level, whereas other securities would show a drastic decline. It is fundamentally true that people sell good securities to protect poor securities, and the result would be that the fund would be liquidated, and a penalty put upon the foresight and acumen of the management for having appraised market action. Indeed, with a fund so large it would take several months to get into a cash position, and if the market were showing a steady rise up to the time of the break, as it did substantially in 1929, the competitors would call attention to the fact that shares of this particular fund were not increasing in value as fast as the shares of a less well managed fund which was not getting into a cash position in anticipation of the market break. This again would cause liquidations. In event sincere management believed that a break

[106] Massachusetts Investors Trust, Incorporated Investors, and State Street Investment Corporation. (Pt. One [House Doc. No. 707, 75th Cong.], Ch. III, pp. 101–5.)

[107] Op. cit. supra, note 84, at 2550–2.

[108] Memorandum submitted to the Commission by Ross Beason, dated June 20, 1937, in connection with the Maryland Funds, Inc., and Quarterly Income Shares, Inc.

was imminent and got into a cash position and the break did not materialize, the competitors would use this as an argument to get out of that particular fund because they had not called the turn.

Any way you look at it the management of funds with liquidating clauses are more or less forced to follow one another like sheep instead of giving the best operation which their studies or efforts may suggest.

Distributors of investment trust and investment company shares attempted to broaden selling appeal by forming a series of open-end investment companies. For example, Calvin Bullock organized a series of open-end investment companies, each of which companies had a different investment policy and theoretically had a different sales appeal. Bullock Fund, Ltd., organized January 26, 1932,[109] possessed a portfolio consisting of a diversified list of bonds, preferred and common stocks, providing what was described as a "balanced, diversified program."[110] Next to be formed, on June 8, 1932, was Nation-Wide Securities Company (a Maryland Corporation) which acquired a diversified "approved" list of common stocks[111] for those investors who were primarily interested in investing or speculating in common stocks. The emphasis was placed upon possible profits through capital gains from appreciation of the common stocks held. On the same date, United States Electric Light & Power Shares, Inc. (a Maryland Corporation) was formed to invest in a selected list of utility stocks.[112] Dividend Shares, Inc., was incorporated on July 23, 1932 (originally as America, Inc.,[113]) primarily to invest in securities producing dividends which the investment company undertook to pay out to shareholders (less expenses) as received.[114] Finally, on November 16, 1932, Canadian Investment Fund, Ltd., was created under the laws of the Dominion of Canada,[115] and this company confined its portfolio almost exclusively to the issues of Canadian enterprises and to American companies doing business in Canada.[116]

Although these investment policies themselves were ostensibly created to serve a variety of investors' needs, a relaxation of certain of the restrictive provisions and practices may be observed. On July 31, 1934, Dividend Shares, Inc., abandoned its "approved" list for the less restrictive charter regulation of a 5% limit upon the assets to be invested in the security issues of any one company.[117] United States Electric Light & Power Shares, Inc. (a Maryland Corporation) never possessed more than $500,000 of assets[118] and the bulk of these funds tended to resemble the typical open-end investment com-

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[109] Reply to the Commission's questionnaire for Bullock Fund, Ltd. (original company), Pt. I (Item 1–d).

[110] Id., Pt. I (Exhibits 9–1 and 9–2).

[111] Reply to the Commission's questionnaire for Nation-Wide Securities Company (a Maryland Corporation), Pt. I (Item 1–d and Exhibit 9–7).

[112] Summary statement supplied the Commission for United States Electric Light & Power Shares, Inc. (a Maryland Corporation).

[113] Op. cit. supra, note 3, Pt. I (Item 1–d, g).

[114] Id. (Exhibits 3–a and 9–1) and Public Examination, Dividend Shares, Inc., at 4157.

[115] Reply to the Commission's questionnaire for Canadian Investment Fund, Ltd., Pt. I, (Item 1–d, e).

[116] Id. (Exhibits 9–1 and 9–2).

[117] Op. cit. supra, note 3, Pt. IV (Item 18–f).

[118] Op. cit. supra, note 54, at 4127–8.

pany portfolio. Hugh Bullock, vice president of Calvin Bullock, admitted this trend toward uniformity when he testified: [119]

Q. Today don't you treat all your trusts as part of your evolution, that is, treating all these trusts as a single unit?

A. We are endeavoring to. We are trying constantly to orient the various portfolios so far as their charters or policies will permit, towards what we call our "controlled" portfolio, which we are endeavoring to adjust all the time. Our so-called "controlled" portfolio represents what we believe at any given time an ideal weighing of an investor's funds.

3. EFFECTS OF RELATIONSHIP OF DISTRIBUTORS AND DEALERS ON OPEN-END INVESTMENT COMPANIES

a. The Influential Position of the Principal Distributor

As a general rule, open-end investment companies did not distribute their shares directly. They sold them either to or through the agency of a corporation, partnership, or other form of business organization, which had the exclusive distribution rights. This organization or individual is referred to in the following discussion as the "principal distributor." [120] The names of the principal distributors of 39 open-end investment companies, as of December 31, 1935, are indicated in Table 9.

The majority of open-end management investment companies were sponsored by persons closely connected with the subsequent distribution of their securities,[121] and practically all of these companies were managed by these same persons. The contracts between these parties with respect to distribution generally reflected this close relationship in their operation, if not in their text.

The essential feature of a typical contract is that it gave the distributor the right to the exclusive distribution of the investment company's securities but did not require any firm commitment on the distributor's part. In other words, the principal distributor ordinarily had an agency contract with the investment company and distributed the shares as agent for the investment company for a specified commission equal to the amount of the load.

Contracts sometimes specified, however, that the distributor, acting as principal, could buy the shares for its own account from the investment company. Where the distributor could act as principal, the opportunities of trading in the trust shares against the interest of the fund were increased.[122]

An analysis of the sale of $440,000,000 of the security issues of 39 open-end investment companies during the 1927–1935 period indicates that 70% were effected by the distributors as agents for these investment companies while only 30% were effected by them as principals. However, a growing tendency has existed during the more

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[119] Id., at 4229–30.

[120] For a discussion of the mechanics of selling the securities of open-end investment companies, see Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 214–16.

[121] See supra, p. 803.

[122] See infra, p. 863.

TABLE 9.—*The principal distributors of open-end investment companies, as of Dec. 31, 1935*

Name of investment company	Name of principal distributor
Administered Fund Second, Inc	Corporate Administration, Inc.
Affiliated Fund, Inc	Lord Abbett & Co., Inc.
American Business Shares, Inc	Do.
American General Equities, Inc	American General Distributors, Inc.
Bullock Fund, Ltd	Calvin Bullock.
Canadian Investment Fund, Ltd	Do.
Century Shares Trust	Brown Harriman & Co., Inc.[a]
Commonwealth Investment Co	North American Securities Co.
Dividend Shares, Inc	Calvin Bullock.
Eaton & Howard Management Fund A-1	Eaton & Howard, Inc.[b]
Eaton & Howard Management Fund B	Do.[b]
Eaton & Howard Management Fund F	Do.[b]
Equity Fund, Inc	Drumheller, Ehrlichman & White.
Fidelity Fund, Inc	Jackson & Curtis.
First Investment Counsel Corp	Scudder, Stevens & Clark.[b]
Fundamental Investors, Inc	Fundamental Group Corp.[c] Mackubin, Legg & Co.
General Capital Corp	Tucker Anthony & Co.
Group Securities, Inc	Distributors Group, Inc.
Income Foundation Fund, Inc	Income Foundation, Inc.
Incorporated Investors	The Parker Corporation.
Investment Trust Fund A	Investors Management Corp.
Investment Trust Fund B	Do.
Investors Fund C, Inc	Do.
Investors Fund of America, Inc	United Sponsors, Inc.
Loomis Sayles Second Fund, Inc	Loomis Sayles.[b]
Maryland Fund, Inc, The	Maryland Sponsors.
Massachusetts Investors Trust	Massachusetts Distributors.
Mutual Investment Fund	Mutual Management Co.
Nationwide Securities Co	Calvin Bullock.
Premier Shares, Inc	Boenning & Co.[a]
Quarterly Income Shares, Inc	Maryland Sponsors.
R. B. C. Fund, Inc	Russell, Berg & Cummings.[a]
Selected American Shares, Inc	Selected Investments Co.
Spencer Trask Fund, Inc	Spencer Trask & Co.
State Street Investment Corp	State Street Research & Management Corp.
Supervised Shares, Inc	Massachusetts Distributors.
Third Investment Counsel Corp	Scudder, Stevens & Clark.[b]
United Gold Equities of Canada, Ltd	Johnston & Ward.[d]
Wellington Fund, Inc	W. L. Morgan & Co.[a]

[a] The principal distributor, if any, at Dec. 31, 1935, is not definitely known. The firm indicated was at one time principal distributor.
[b] This trust was sponsored and managed by the investment counsel firm indicated. This firm also acted as agent in the distribution of the shares, but is not comparable to other distributors.
[c] Mackubin, Legg & Co. was apparently the active distributor at Dec. 31, 1935.
[d] Technically, the principal distributor was Stanley Johnston, as an individual, and not his firm, Johnston & Ward.

recent years for distributors to act as principals.[123] This tendency towards the principal rather than agency relationship with the investment company has been attributed by members of the industry primarily to two factors: First, the fear that an underwriter's liability under the Securities Act of 1933 may be imposed upon the dealers

[123] Compiled from the replies to the Commission's questionnaire for 39 open-end management investment companies, Pt. IV. None of these figures include sales made of shares reacquired by dealers and distributors which were not turned back to the investment companies. In the year 1935, 61.5% of the $81,373,000 of open-end investment company shares distributed were sold to the distributor as principal. (Ibid.)

when the principal distributor acts only as agent and, second, the possible liabilities which may be imposed upon the investment companies as principal by virtue of misrepresentation which may be made by the principal distributor, as agent, in connection with the sale of the shares.

The personal relationship between the principal distributor, the sponsor, and the manager of an open-end investment company as well as the contractual relationship between the principal distributor and the investment company are illustrated by the Calvin Bullock group. Calvin Bullock, a New York joint stock association, sponsored five open-end management investment companies during the one year of 1932.[124] The original officers of these companies, who were also members or employees of Calvin Bullock, appointed that joint stock association as the principal distributor for each company. In addition, each of these open-end investment companies entered into a management contract with Calvin Bullock.[125] This identity of parties and personnel assured the continuance of the distribution and management contracts for Calvin Bullock as well as control over these various investment companies without the necessity for any stock ownership in these companies.

This contractual relationship between the principal distributor and the open-end investment company is typified by the distribution contract between Calvin Bullock and Dividend Shares, Inc., dated July 30, 1932.[126] This contract, among other things, required Calvin Bullock to purchase 6,900 shares for $7,100 and appointed that joint stock association as the exclusive selling agent for 10 years and 5 months and thereafter from year to year until terminated upon 12 months' notice. The contract established a retail price for shares approximately equivalent to asset value plus a selling load of 9½% of such value; required the underwriting of all sales by Calvin Bullock and the payment of cash at or prior to the time of delivery of shares; and provided for the issuance of current information concerning the investment company for the use of the distributor. Further, the contract gave Calvin Bullock the right to trade as principal, as follows:[127]

> It is also understood that you shall at all times be free to purchase shares for your own account upon the same terms as have been specified above for your accounting to us with respect to shares sold for our account; and also that you may at all times freely trade in our shares for your own account.

Calvin Bullock has acted in the capacity of principal in connection with the distribution of the shares of all Bullock open-end companies since 1933.[128] The reason asserted for the change from its former

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[124] See supra, p. 822.

[125] At December 31, 1936, all of the principal officers and directors of Nation-Wide Securities Company, United States Electric Light & Power Shares, Inc., and Dividend Shares, Inc., were also directors and officers of Calvin Bullock (a New York joint stock association). All of the principal officers and 3 of the 7 directors of Bullock Fund, Ltd., were also officers and directors of Calvin Bullock. Two of the 6 principal officers and 3 of the 10 directors of Canadian Investment Fund, Ltd., were also officers and directors of Calvin Bullock. (Derived from supplementary information supplied the Commission for Bullock Fund, Ltd.)

[126] Op. cit. supra, note 3, Pt. I (Exhibit 6–1).

[127] Ibid.

[128] Derived from supplementary information supplied the Commission for Calvin Bullock Trusts.

agency position to a principal status was an endeavor to make certain that the dealers would not be considered principals in any transaction with the investment companies and, therefore, "underwriters" under the Securities Act of 1933.[129]

The greater part of the repurchases made by open-end investment companies was also made through the distributor as agent in the 1927–1935 period. Of a total of $112,047,000 of repurchases reported during this 9-year period, approximately 80% was made in this manner and 20% was repurchased from the distributor with the latter acting as a principal in the transaction.[130] However, the figures for repurchases here summarized represent only those repurchases made by the investment companies themselves and do not include the turnover of shares upon the markets maintained independently by principal distributors and dealers, which were not reported.

b. The Dependence Upon the Dealer

Certain aspects in connection with the distribution of the shares of open-end management investment companies make this type of securities business attractive from the point of view of the dealer. These aspects are: the distribution of open-end investment company shares constitutes a continuing business; the dealers' spread or commission is at least as high as on other types of securities;[131] neither minimum nor firm commitments are required; repurchase penalties on the placement of shares are not levied; substantial inventory position in the shares is not necessary; little or no capital is required; and, finally, dealers are substantially free from effective regulation or control by the investment companies and their principal distributors.

The existence of the open-end investment company depends upon the sale of its shares in a highly competitive field which it usually accomplishes through a large nation-wide dealers' organization. Calvin Bullock had a total of about 2,000 dealer outlets over the country of which 700 or 800 have been active at a given time.[132] Similarly, Massachusetts Investors Trust had 500 or 600 dealers operating on a nation-wide basis,[133] while Incorporated Investors had 300 or more dealers on the books of whom 60 or 70 were active.[134] Since almost all dealers handled or had the opportunity to handle the shares of two or more competing open-end investment companies at the same time, the maintenance of dealer good will by the principal distributor and the investment company became of paramount importance.

This dependence upon the dealer has found expression in many phases of open-end investment company activities. As has been indicated, competition among open-end investment companies has prevented the reduction of loading charges.[135] Furthermore, various

[129] Ibid.

[130] Compiled from the replies to the Commission's questionnaire for 39 open-end management investment companies, Pt. IX. Prior to the last quarter of 1929, repurchases were reported as 100% upon agency basis; thereafter, repurchases as agent ranged from 67% to 82%. (Ibid.)

[131] See supra, pp. 813 et seq., and infra, pp. 847 et seq.

[132] Op. cit. supra, note 54, at 4199.

[133] Op. cit. supra, note 63, at 2490.

[134] Op. cit. supra, note 84, at 2703.

[135] See supra, p. 809.

selling practices, as hereafter related,[136] were indulged in, sometimes with the active support of the investment companies involved. In short, any device or practice which would facilitate the task of the dealer might be adopted or encouraged by open-end investment companies in order to assure the continued sale of their securities.

Dealer influence with respect to the formation of new trusts was described by John S. Myers, chairman of the board of directors of Distributors Group, Incorporated, as follows:[137]

Q. But that is not—is that sufficient reason to—for you, as a selling organization, to sell a trust?

A. Of course. We would give the dealer anything that he asked for, that we felt was sound.

Q. So that I suppose that you have your ear to the ground all of the time, in contacts with dealers, to know what they think that they can sell, and then if you think that is a proper vehicle, then you make it up and send it out.

A. And if we think that it is likely to be a successful venture on our part, of course.

This influence of the dealer was also recognized by Cedric H. Smith, vice president of The Maryland Fund, Inc. and Quarterly Income Shares, Inc. organized by the Ross Beason and Company group as two open-end management investment companies:[138]

Q. Is it true that in your judgment the public reacts better, that is, buys more trust shares, if you instead of selling the same trust over a period of time you bring out a new trust with a different name?

A. It is not so much a question of public reaction as it is the fact that the dealer organization which comprises a large number of individual salesmen gradually wear themselves out and get tired of constantly selling exactly the same product. That is true not only in the securities business, but it is a general truth that applies to practically all types of merchandising.

Q. You mean that in order to keep the public interested in your product you have to change at least the superficial appearance of your product from year to year in order to keep not only the public, but your own retail sales force interested?

A. It is primarily a matter of keeping your retail sales force interested, because regardless of the public's attitude, the public will not buy securities, or buy any product, for that matter, unless some salesman calls it to their attention.

Similarly, the use of the preferential bid on exchanges of trust shares by Nation-Wide Securities Company was apparently inspired by dealers. Hugh Bullock testified:[139]

Q. * * * what led up to putting that provision in the charter and submitting it to the stockholders?

A. Perhaps the best answer is that it was the fashion of the day. Our dealers, seeing that comparable provisions in certain other investment trusts, asked us to incorporate it, and when a sufficient number had requested us to

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[136] See infra, pp. 829 et seq.

[137] Public Examination, Distributors Group, Incorporated, at 10317. Distributors Group, Incorporated, was a sponsor of Group Securities, Inc., an open-end investment company, as well as depositor for several fixed trusts.

[138] Public Examination, Ross Beason and Company Group, at 11399.

[139] Op. cit. supra, note 54, at 4170–1.

take that action, we did so, because certainly it was not to the disadvantage of Nation-Wide itself, in fact, slightly to its advantage.

* * * * * * *

Q. What I am getting at, weren't you really forced to adopt this by your dealers in order to sell these shares?

A. I wouldn't put it that way.

Q. But wasn't very strong pressure brought upon you to adopt this set-up?

A. The correct answer, in my opinion, would be "yes."

Q. Isn't that another indication of the dictation by the dealer?

A. You are referring to his major dictation of what he demands for selling securities?

Q. Yes.

A. That is the major one.

The dependence of open-end investment companies upon numerous dealers for the distribution of their shares usually discouraged any effort to supervise or restrict the dealers' trading activities. The relationship between Calvin Bullock and its dealers was stated in the prospectus of Dividend Shares, Inc., dated July 23, 1938:[140]

Calvin Bullock has no agreements with dealers requiring them to purchase shares only against their customers' orders, or prohibiting dealers from purchasing shares for inventory purposes or from selling short. Neither the company nor Calvin Bullock knows the extent to which the latter practices are engaged in by dealers or the amounts of profits, if any, made or to be made as a result of such practices.

On the other hand, National Investors Corporation sought to prohibit its principal distributor and dealers from buying its shares for their own accounts and written agreements were entered into between the distributor and the dealers which required that all orders should be bona fide customers' orders.[141]

Mahlon Q. Traylor, president of Massachusetts Distributors, Inc., stated that some effort was made to be selective in the appointment of dealers for the sale of the shares of Massachusetts Investors Trust and Supervised Shares, Inc.:[142]

Q. Do you have any trouble at all with dealers misrepresenting the shares? Have you heard of instances of that?

A. If they have I know nothing about it. I would add this further word, that both in New York and in Boston we have tried to be very careful in the selection of dealers who sell these shares, because it makes for a healthier situation. As I say, we want them sold right and to the right people. Our whole stock in trade as a sales organization is the goodwill of the people we spent years in cultivating, and we must do everything within our power to protect that goodwill. And I believe that in the selection of our dealers we have been careful enough, although we don't know what all of the salesmen who sold Massachusetts Investors Trust Shares might say I believe that on the whole Massachusetts Investors Trust [shares] have been sold on a pretty sound basis.

The amount of care which the distributor could exercise in the selection of 500 to 600 dealers was necessarily limited.

[140] Registration Statement, 1933 Act, Dividend Shares, Inc., File No. 2–3588–1.

[141] Op. cit. supra, note 102.

[142] Op. cit. supra, note 63, at 2507.

4. SELLING PRACTICES

Open-end investment companies developed along with other special types of investment companies—fixed and semifixed investment trusts, installment investment plans, and companies issuing face amount installment certificates—to which sponsors turned after the market break in the fall of 1929.[143] Shares of these types of companies were sold on a door-to-door basis and a number of selling practices were common to all types. Sales campaigns were conducted vigorously, and dealers, distributors, and sponsors employed almost every merchandising device in their selling efforts.[144] New models of open-end investment companies under common sponsorship and management were periodically formed; offers were made to trade open-end investment-company shares for shares of other investment companies; installment selling and stock dividend devices were employed to increase selling appeal; leverage was added to the capital structures through the issuance of senior securities and the pyramiding of open-end investment companies; and concentrated advertising methods, including radio programs, selling literature, and extensive spreads in newspapers and periodicals were employed to keep the names of these companies constantly before the public.

a. Organization of Groups of Open-End Investment Companies

Some sponsors organized groups of different types of investment trusts or investment companies. Thus, Calvin Bullock initiated a series of fixed and semifixed investment trusts, management investment companies without open-end provisions, and management investment companies with open-end provisions concurrently with changing economic conditions and investors' receptivity. Ross Beason and Co., Inc., followed the same cycle. Both these sponsors made exchange offers to their fixed trust shareholders for the shares of newly organized open-end investment companies.[145]

The open-end investment companies formed by Calvin Bullock were individually styled to provide specialized types of investment vehicles so as more completely to reach all sections of the investing public.[146] On the other hand, the two open-end investment companies of the Ross Beason group, Quarterly Income Shares, Inc., and The Maryland Fund, Inc., both appealed to the same type of investor, but their successive formation provided the desired psychological effect.[147]

Quarterly Income Shares, Inc., organized on December 9, 1932,[148] as a restricted management open-end investment company, offered its shares continuously to the public from December 12, 1932, through February 28, 1935.[149] Although by the latter date all of the authorized capital stock had not been issued, the selling period was termi-

[143] For a further discussion see Ch. I of this part of the report, pp. 4–5.

[144] Open-end investment companies sponsored by investment counsel usually sold their shares directly to friends, associates, and clients of the sponsors. See also supra, p. 803.

[145] See Ch. I of this part of the report, pp. 26–31.

[146] Op. cit. supra, note 54, at 4215–6.

[147] Public Examination, Ross Beason and Company Group, at 11396, 11367.

[148] Id., at 11322, 11324.

[149] Id., at 11366.

nated. The open-end provision for the repurchase of shares contained in the charter had been amended as of August 23, 1934 to permit its termination if and when the shares should be listed upon a stock exchange in a city of 2,000,000 or more population.[150] Distribution was discontinued because sales resistance on the part of investors was becoming equal to sales pressure. Lawrence H. Schmidt, director and secretary-treasurer of Quarterly Income Shares, Inc., testified as follows with respect to the termination of the selling period:[151]

Q. You did not sell all your authorized capital stock, did you?

A. No; we did not.

Q. Why did you stop offering to the public?

A. We stopped offering to the public when we did because we wanted to discontinue the offer before the market was saturated.

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Q. Why was that?

A. Because we felt it would be much more desirable to conclude the selling period, to terminate it abruptly, rather than to let it continue on and allow the market to become more and more saturated.

In order to overcome sales resistance and increase distribution, a new open-end investment company, The Maryland Fund, Inc., was formed by the same sponsors on June 22, 1934, about 8 months prior to the termination of the offering of Quarterly Income Shares, Inc. The charter of this company also permitted the termination of the open-end provision at the election of the board of directors after listing upon a stock exchange.[152] Selling activities were shifted to The Maryland Fund, Inc., after August 1, 1934.[153]

It was the plan of the sponsors of Quarterly Income Shares, Inc. and The Maryland Fund, Inc. to continue organizing new investment companies until the aggregate funds of these companies totaled $250,000,000. Mr. Schmidt testified:[154]

Q. * * * so that the public is constantly receiving a new model of trust from your sponsors? Is that correct?

A. Not a new model, necessarily. It may, as in the case of the Maryland Fund, be substantially similar. Our hope is over a period of time to build up a number of investment trusts similar in nature to Quarterly Income Shares, Incorporated, and Maryland Fund, Incorporated.

Q. I see. So that you will never arrive at the point where your securities distribution is completed and you are engaged totally in management? Is that correct?

A. We expect to arrive at the point when we feel that the total amount of investment funds * * * has reached the point beyond which supervision might become involved.

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[150] Reply to the Commission's questionnaire for Quarterly Income Shares, Inc., Pt. I Open-end provisions were reestablished in 1936, so as to comply with the provisions of the Revenue Act referring to mutual investment companies. (Op. cit. supra, note 147, at 11369–70.) See discussion, supra, p. 801.

[151] Op. cit. supra, note 147, at 11366.

[152] Reply to the Commission's questionnaire for Maryland Fund, Inc., Pt. I.

[153] Op. cit. supra, note 147, at 11367.

[154] Id., at 11396–7.

Q. I see.

A. The figure we have tentatively in mind as a stopping point is approximately $250,000,000.

As in the case of the Calvin Bullock group,[155] Ross Beason and associates initiated exchange offers between the fixed investment trusts and the open-end management investment companies within the Ross Beason and Company group. Approximately $15,000,000 of the shares, or half of all sales of stock by Quarterly Income Shares, Inc., were issued by exchanges with the stockholders of the other investment trusts in the Ross Beason and Company group.[156]

Group Securities, Inc., a unique open-end investment company of the management type, was incorporated under the laws of Delaware on December 5, 1933, and commenced business on January 12, 1934.[157] The sponsors of this investment company were Fenner & Beane, members of the New York Stock Exchange, and Distributors Group, Inc., depositor-sponsor of a series of fixed trusts known as North American Trust Shares.[158]

The distinguishing feature of Group Securities, Inc., was the creation of various classes of stock, each of which represented an equity in a separate industry or type of underlying security. The certificate of incorporation restricted neither the character nor the number of such classes of stock. Originally 17 different groups of industries were provided. With the addition of an investment company group on December 1, 1934, the different industrial groups to the end of 1935 were as follows: agriculture, automobile, aviation, building, chemical, distillery and brewery, electrical equipment, food, industrial machinery, investment companies, merchandising, mining, petroleum, railroad, railroad equipment, steel, tobacco, and utilities.[159]

The investor could purchase shares representing an interest in the securities of any one industry group or could obtain the diversification he desired by buying varying amounts of shares in the different groups.[160] Or, the investor could purchase "ready-made" diversification by buying shares representing an interest in the investment company group which consisted of a diversified list of investment companies with diversified portfolios.[161] A shareholder in one group was permitted to switch to another group at a reduced load.[162]

The basic set-up of Group Securities, Inc., is such that the investor must make the most important investment decisions. He determines

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[155] Op. cit. supra, note 54, at 4176, 4213.

[156] Op. cit. supra, note 147, at 11358.

[157] Reply to the Commission's questionnaire for Group Securities, Inc., Pt. I.

[158] Id., Pts. I and IV.

[159] Id., Pt. V.

[160] Derived from supplementary information supplied the Commission for Group Securities, Inc.

[161] Ibid. It is interesting to note that no open-end investment companies were included in this investment company group so that a double loading charge was avoided. Further, closed-end companies could be purchased at discounts below asset value. Investors in this group, however, could not avoid a doubling of management charges. (Ibid.)

[162] Only 50% of the normal load was charged on a switch. Although the sponsors denied that the 1% gross profit received by them on such switches offered any inducement to trade out their shareholders from one group to another, they undoubtedly stimulated such switching through the issuance of various industry analyses from time to time. Switching was still profitable for dealers, however. (Ibid.)

the particular industries in which to invest, the amounts to be invested in those industries, whether to shift from group to group and the extent of such shifts. The management merely determines the companies to be included in the industrial groups. The investment results in great measure are therefore attributable to the decisions or "management" of the investor rather than the judgment of the managers—judgment which the investment company purports to provide.[163]

b. Use of Preferential Bid and Load Discounts

The preferential bid is a premium offered by distributors of the shares of an investment trust or investment company or by the investment trust or company itself for the shares of another investment trust or company which has a redemption feature, to induce shareholders to switch their investments to the offering company. In most instances the offer has been limited to other investment companies in the same group for the purpose of taking old investors into the new vehicle, or to prevent the loss of the old investor to the group by reason of outside pressure to switch his investment. Such premiums were in some cases authorized by the charters of the investment companies.

As has been indicated, dealers induced the inclusion of provisions in the certificate of incorporation of Nation-Wide Securities Company which facilitated preferential bids for fixed trust shares of the Bullock group.[164] In further explanation of the use of the preferential bid in this investment company, Hugh Bullock testified:[165]

Q. * * * How many of these companies would you say had been active in trading your investors out of your shares?

A. I would say, from experience, probably all of them.

Q. All of them?

A. Yes; I won't say that all had this preferential bid, but they tried to get other people's clients, obviously the way the security business is done.

Q. Would you characterize this in part as retaliatory?

A. No; in no fashion. I definitely characterize it as an element of self-protection.

The economic theory upon which this preferential bid—an offer to purchase the shares of the other investment company at 3% above the redemption or asset value of these shares or in other words a premium of 3% of asset value—could be made, was that Nation-Wide Securities Company, by presenting for redemption the shares received upon the exchanges, would receive underlying securities which were identical with the stocks needed for its own portfolio without paying regular brokerage and transfer charges.[166] Nevertheless, many of the investment trust or investment company shares received from the

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[163] Under a contract dated December 6, 1933, the sponsor, Distributors Group, Inc., agreed to provide advisory, research, and statistical services to Group Securities, Inc., for an annual fee of ⅜ of 1% of the net assets, at market, of the investment company. Distributors Group, Inc., simultaneously made a management contract with Dean Langmuir, Inc., independent investment counsel, covering all of the investment companies sponsored by Distributors Group, Inc. (Op. cit. supra, note 157, Pt. I.)

[164] See supra, p. 827.

[165] Op. cit. supra, note 54, at 4177–8.

[166] Id., at 4170–2.

operation of the preferential bid were resold on the market. Thus, where complete units of fixed trust shares could not be assembled to be redeemed, such trust shares were regarded as temporary investments and subsequently disposed of.[167]

This policy of acquiring trust shares as temporary investments raised objections from the state security commissions of Kansas, North Carolina, Ohio, and Wisconsin.[168] The objectionable features included the possible temporary investment in securities of issuers not contained in the charter list of approved underlying companies, and the gross commission of 9½% upon the liquidating value of the new shares, which the principal distributor could charge for consummating the switch.[169] The practice of making temporary investments was discontinued in 1934 in compliance with the provision of the Investment Bankers' Code prohibiting rebates in price.[170]

Lawrence Schmidt, director and secretary-treasurer of Quarterly Income Shares, Inc., of the Ross Beason and Company group, which also employed the preferential bid, explained the theory as follows:[171]

A. At that time a great many fixed trust shareholders, because they wanted a more flexible investment vehicle, were selling their shares and reinvesting the proceeds in stocks of management or restricted management companies. That process involved the payment by that shareholder of stock exchange commissions on the stocks included in his fixed trust shares and involved the payment indirectly of stock exchange commissions involved in the purchase of many of those same stocks by the limited management company after he became a shareholder. Do you follow that? I might clarify that with an example.

We will assume that a fixed trust shareholder had an interest in a portfolio containing the stock of American Telephone & Telegraph Company. If he sold his shares, liquidated them through the trustee, he had deducted from his proceeds the cost of the odd-lot brokerage and stock exchange commissions involved in the sale of American Telephone & Telegraph stock. If he then took the proceeds of the sale of his shares and used those proceeds to purchase stock in the limited management company, the limited management company, in turn, would most likely also have American Telephone & Telegraph stock in its portfolio and would then use the investment proceeds of the sale of its own shares to the investor to purchase the American Telephone & Telegraph stock and again pay a buying commission so that the investor was definitely subjected to, you might call it, economic waste involved in two-way commissions.

Under the terms of the charter provision, which I have just described, it was possible for Quarterly Income Shares, Inc., to pay the investor the current market price of American Telephone & Telegraph stock and the buying commissions, an amount equal to the buying commission which it would have to pay anyway for the purchase of shares on the exchange, so that the shareholder not only saved those selling commissions but he also saved the buying commissions.

Q. Now, when you made an exchange offer to holders of your own fixed trust shares, to get any Quarterly Income Shares, your allowance was a part of or

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167 Id., at 4171.

168 Reply to the Commission's questionnaire for Nation-Wide Securities Company, Pt. IV (Item 32).

169 Ibid., and op. cit. supra, note 54, Commission's Exhibits Nos. 408 and 409.

170 Op. cit. supra, note 54, at 4179.

171 Op. cit. supra, note 45, at 11335–7.

all the saving that you could effect through that process you just described. Is that correct?

A. That is correct.

This policy of making temporary investments in the trust shares obtained by the preferential bids also created "Blue Sky" law difficulties for Quarterly Income Shares, Inc. For instance, the Securities Commission of the Corporation Division of North Carolina issued an Order of Declination dated April 21, 1933, stating that it appeared that the proceeds from the sale of the investment company's shares were to be invested temporarily in Corporate Trust Shares, another investment trust sponsored by the same group and that this would result in pyramiding one investment trust upon another. Further the Corporation Commission stated that the load of Quarterly Income Shares, Inc., plus the load of Corporate Trust Shares was in excess of the 10% maximum load allowed by law, over and above the cost of the underlying securities on the stock exchange.[172]

If the interest of the individual investor might be threatened by efforts of competing investment funds to trade out his holdings, the same possibility existed in perhaps aggravated form where special inducements were offered for switches into investment companies having a common sponsor.

A reduction in the normal loading charge was sometimes granted to induce increased sales of open-end investment company shares. Thus, after February 28, 1936, the distributor, Calvin Bullock, was authorized to reduce or eliminate the sales load on the shares of Dividend Shares, Inc., where that distributor was appointed by investors to act as their agent in liquidating holdings of securities possessing open-end features in order to invest the proceeds in the stock of Dividend Shares, Inc.[173] Another method used to increase sales was to give discounts from the normal load on large orders. State Street Investment Corporation reserved the right to reduce or eliminate the load on all sales of blocks of its shares of $100,000 or more,[174] and Calvin Bullock could reduce or eliminate the selling commission on shares of Bullock Fund, Ltd., in sales amounting to $25,000 or over.[175] Axe-Houghton Fund A, Inc., and Axe-Houghton Fund B, Inc., organized on August 5, 1938, under the sponsorship of E. W. Axe & Co., Inc., investment counsel, established a sliding scale of loading charges. Thus, the first $5,000 of the sale price of an individual block of such shares carried the full load of 5% of the asset value while increased amounts bore successively reduced rates to only ¼% on sums in excess of $75,000.[176] Similarly, in the sale of the shares of Institutional Securities, Ltd. discounts from the commission of 7½% of the offering price were originally allowed on single orders of substantial size, of ½% of the aggregate retail offering price on orders from $10,000 to $22,499, to 5% on all orders of $250,000 or over. Further special discounts were allowed on special retail sales involving the reinvesting of proceeds of sale or redemption of other investment shares.[176a]

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[172] Reply to the Commission's questionnaire for Quarterly Income Shares, Inc., Pt. IV.

[173] Op. cit. supra, note 3, Pt. IX.

[174] Op. cit. supra, note 46, Pts. I and IX.

[175] Reply to the Commission's questionnaire for Bullock Fund, Ltd. (new), Pt. IX.

[176] Registration Statements, 1933 Act, Files Nos. 2–3776–1 and 2–3777–1.

[176a] Registration Statement, 1933 Act, File No. 2–2115.

c. Reaching the Small Investor

Stock split-ups, stock dividends, and installment selling were used by some open-end investment companies to create broader appeal for their shares. Stock split-ups and stock dividends reduced the cost per share to the prospective purchaser and so broadened the potential market.[177] Installment selling, by allocating the cost of the shares purchased over a period of time, increased and perhaps over-extended the purchasing power of the investor.

Hugh Bullock admitted that a six-for-one stock split-up in the shares of Nation-Wide Securities Company on September 14, 1933, was to aid sales by reducing the price per share.[178] Similarly, Incorporated Investors made stock distributions of 100% in 1928 and 50% in 1929 to diminish the per share asset value and consequently the selling price.[179] William A. Parker, president of this investment company, testified in this regard:[180]

Q. That is another factor that made selling easier, because it reduced the price?

A. Let us put it differently. Let us say where the trust was designed for people of moderate means that it made it more available for those of moderate means.

Incorporated Investors also made periodic 5% stock distributions during the 1927–1935 period which represented a division of capital rather than a distribution of earnings.[181] A prospectus to investors emphasized this "dividend" policy as a "convenient way by which the shareholder who needs to secure a larger income may do so by selling a stock dividend."[182] Thus, these distributions served to spice the low yield portfolio of Incorporated Investors and, hence, induced sales by giving the appearance of a steady income.[183] Mr. Parker testified further:[184]

Q. So that your yield was not a great selling point?

A. No; nor has it ever been.

Q. You compensated for that by a 5 percent stock dividend which, if I understand it rightly, was to put you into a position so that you would be on a comparable basis with high-yield stocks?

A. Well, perhaps that is a reasonable way to put it. It was our contention * * * that the ordinary individual, let us say, of moderate means, for whom these mutual companies are organized, found it very hard, at least in our opinion, to decide what securities he should buy. He was tempted to buy XYZ Preferred that yielded 8 percent. In the course of running Incorporated Investors we felt it necessary or deemed it wise to buy many low yield securities. At the same time, we felt that this is the proper kind of security in the aggregate in its diversified form that the person of moderate means should buy. Feeling that he would not be willing to buy securities on so low a yield, we

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177 Similarly, dividends, whether in cash or stock, reduced the per share value of the stock outstanding.

178 Op. cit. supra, note 54, at 4167.

179 Op. cit. supra, note 84, at 2596.

180 Ibid.

181 Id., at 2562–3.

182 Ibid. and Commission's Exhibit No. 291.

183 Id., at 2562.

184 Ibid.

offered him in essence a return of capital which would make it possible for him to do it.

Q. That also helped your selling of the securities, didn't it?

A. Surely, I think.

Q. And that was a return of capital?

A. Yes; I think that is a fair statement.

Q. When you sent out those dividends of 5 percent was it represented to the stockholders at the time you sent it out that it was a return of capital? In none of the material I see here do I understand it was.

A. I do not think that was as clearly labeled as I should label it today. I do not think there is any question about that.

These stock distributions also stimulated trading in fractional scrip which shareholders were urged to purchase in order to round-out their holdings.[185]

Installment selling of the shares of open-end investment companies assumed a variety of forms and accounted for a limited volume of sales. The following are illustrative of some of the set-ups adopted to market the shares of open-end investment companies on the installment basis.[186]

In 1930 ten investment dealers in various parts of the country organized and operated Parco Plan Clubs, named for The Parker Corporation, principal distributor for the voting trust certificates in the shares of Incorporated Investors.[187] Participants in these clubs made optional monthly deposits in multiples of $10 which, together with dividend accumulations, were used to purchase shares of Incorporated Investors to be held by The First National Bank of Boston. An entrance fee of $5 and annual maintenance fees of $3 were charged each participant by the local dealer managing the club. No substantial volume of sales was expected by this means[188] and the clubs were finally liquidated in 1935.[189] A so-called installment and insurance plan, known as Protected Investors of America of San Francisco, California, also used the shares of Incorporated Investors as underlying securities, which shares were purchased by the plan on a dealer basis.[190] This plan or fund was operated independently of the investment company and its principal distributor, who could supply no detailed information as to the nature of the operation of the plan.

So, too, The Massachusetts Company was organized July 1, 1930, by Hovey E. Slayton, at the time president of Slayton-Learoyd, Inc. (now Massachusetts Distributors, Inc.) to assist investors in the purchase of shares of Massachusetts Investors Trust upon a partial payment basis.[191] This company did not sell shares to customers but merely financed partial payment plans for investors. During the period 1930–1935, inclusive, this company made 2,288 contracts cover-

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[185] Id., at 2596.

[186] See also the Commission's supplemental report on Companies Sponsoring Installment Investment Plans.

[187] Op. cit. supra, note 5, Pt. V (Item 46 and Exhibit 1).

[188] Op. cit. supra, note 84, at 2597–8.

[189] Op. cit. supra, note 5, Pt. V (Item 46).

[190] Ibid. As at December 31, 1936, Title Insurance & Guaranty Co. of California held 10,547 shares of Incorporated Investors as custodian for approximately 1,000 investors. (Derived from supplementary information supplied the Commission for Incorporated Investors.)

[191] Op. cit. supra, note 41, Pt. V (Item 46).

ing the purchase of approximately 49,345 shares at an aggregate cost of $1,158,294.[192] The practice was for the investor to make a cash payment, ranging upward from 25% to 50% of the purchase price, or to provide additional collateral, and to receive from 5 to 24 months' credit upon the unpaid balance. The investor then gave his note for the balance due which included in the face amount a $5 service charge and straight interest of from 2% to 11½%, depending upon the number of deferred monthly payments. The stock so purchased was retained as collateral security.[193]

In addition the installment investment plan companies sometimes utilized the shares of open-end investment companies as their underlying securities.[194] Thus, Income Foundation, Inc. was the sponsor and depositor for the installment investment plans known as Income Foundation Investment contracts, Plans A to G, and Income Foundation Fund Trust Certificates, Plans A to E.[195] Income Foundation Investment Contracts, Plans A, B, and C, had fixed trusts as their underlying securities, but on October 6, 1932, trust agreements were executed for Plans D and E which had Bullock Fund, Ltd., and for Plans F and G which had Nation-Wide Securities Co. (of Maryland), both open-end investment companies but which apparently had no connection with this sponsor.[196] The installment investment plan procedure was for the trustee to purchase shares of the underlying open-end investment companies with the payments made on the installment investment plan certificate (less the sales loads on these certificates) and to credit each certificate holder with his interest in such underlying open-end investment company shares.[197] From 1932 through 1935, a total of $388,655 was paid into these four installment investment plans.[198]

In 1935 sales of the foregoing plans were terminated in favor of Income Foundation Fund Trust Agreements and Certificates of Trust, Plans A to E, installment investment plans created by a trust agree-

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[192] Ibid. This compares with total sales of shares of Massachusetts Investors Trust of $67,290,929 during the same period. (Id., Pt. IX [Table 44].)

[193] Op. cit. supra, note 41, Pt. V (Exhibits E–2 and E–3). Another selling plan in connection with the shares of Massachusetts Investors Trust was known as Reinvestment Associates, series A to F, and Massachusetts Investors Cumulative Trust Units, series G, H, and I, a group of irrevocable trusts maturing in approximately 6 years. This was not an installment plan but a device for the purchase of such shares in units of $500, the dividends from which, after the payment of expenses, were to be reinvested in the trust shares. This series of nine trusts was created by the principal distributor for Massachusetts Investors Trust between October 5, 1927, and May 15, 1931, and represented a capital investment of $1,217,000. (Derived from summary statements supplied the Commission for the respective trusts.)

[194] North American Bond & Share Bond and Participation Certificates was such an installment investment plan, investing in the shares of Massachusetts Investors Trust, while Protected American Investors, mentioned in this section, supra, was also probably of this type. For a full discussion of such investment vehicles see the Commission's report on companies sponsoring installment investment plans. See also discussion of T. I. S. Management Corporation, infra, pp. 847 et seq.

[195] Replies to the Commission's questionnaire for Income Foundation Investment Contracts and for Income Foundation Fund Trust Certificates.

[196] Reply to the Commission's questionnaire for Income Foundation Investment Contracts.

[197] Ibid. The usual certificate was for a face amount of $1,200 payable $10 a month, and carried insurance provisions upon the life of the investor for the unpaid balance. (Id., Table 11 and Exhibit A.)

[198] Op. cit. supra, note 196, Table 9.

ment dated November 20, 1934.[199] One of these plans consisted of fully-paid subscriptions while two of the remaining installment plans carried insurance features. A distinguishing characteristic of this new group of installment investment plans was that the underlying shares were issued by Income Foundation Fund, Incorporated, an open-end management investment company also under the sponsorship of Income Foundation, Incorporated.[200] Gross sales of the shares of Income Foundation Fund, Incorporated, which were offered only through the medium of these investment plan certificates, amounted to $571,034 to December 31, 1935.[201]

Yet another type of installment investment plan company, which in many respects resembles the open-end investment company, is exemplified by Euclid Investment Trust Certificates, created under a trust indenture dated December 29, 1930, by Euclid Investors, Inc.[202] This was a 10-year investment plan into which the investor deposited $10 a month (or multiples thereof) for a total of $1,260, which included an initial payment or service fee of $60 for the privilege of investing $1,200 in the trust fund.[203] The proceeds of these payments were invested by the trustee at the direction of the sponsor directly in a commingled group of diversified listed securities[204] and 75% of the earnings if any were distributed to investors.[205] An investor not in default could withdraw at any time and receive his approximate pro-rata interest in the fund but a 90-day notice could be required. In the event that a contract was lapsed, the sponsor, at its election, could advance future payments as a loan against the investor's equity.[206] As at December 31, 1935, a total of $92,000 had been paid into the fund for certificates representing a face amount of $961,200.[207]

d. Open-End Investment Companies with Leverage

Although open-end investment companies almost invariably had only one class of shares of stocks, at least one open-end company—Affiliated Fund, Inc.—had senior securities in its capital structure.[208]

Affiliated Fund, Inc.

Affiliated Fund, Inc., formerly Affiliated Investors Fund, Inc., was incorporated May 14, 1934, under the laws of Delaware as an open-end

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[199] Ibid., and reply to the Commission's questionnaire for Income Foundation Fund Trust Certificates.

[200] Reply to the Commission's questionnaire for Income Foundation Fund Trust Certificates.

[201] Reply to the Commission's questionnaire for Income Foundation Fund, Incorporated, Pt. V (Item 46) and Pt. IX (Table 44).

[202] Reply to the Commission's questionnaire for Euclid Investment Trust Certificates (Item 1).

[203] Ibid.

[204] The trust indenture provided certain percentage limitations upon the investment policy and provision for elimination after the passage of dividends. (Id., Item 32.)

[205] The sponsor's management compensation was 25% of the earnings before dividends, while the trustee received 1% per annum of the quarterly value of the fund. (Op. cit. supra, note 202, Item 32.)

[206] Op. cit. supra, note 202, Item 32.

[207] Id., Tables 9 and 10. Contracts in the face amount of $385,200 were in effect at December 31, 1935. (Id., Table 11.)

[208] For discussion of problems in connection with multiple-security capital structures of open-end companies, see Pt. Three, Ch. V, infra.

leverage investment company of the restricted management type.[209] This investment company was originally sponsored by Thomas F. Lee and associates, but since November 20, 1934, sponsorship and management functions have been assumed by Lord, Abbett & Co., Inc., and affiliated companies.[210] As at December 31, 1936, the capitalization consisted of $122,800 of 10-year convertible debentures due 1944, $357,950 of debentures due 1945, $369,750 of debentures due 1946, and 199,800 shares of capital stock with a par value of $1.25 per share.[211]

Each share of common stock represented a pro rata equity in the net assets of the investment company subject to the prior claim on property deposited with the Trustee for payment of principal and interest on debentures.[212] Shares of the capital stock were sold by Lord, Abbett & Co., Inc., the principal distributor; were priced at asset value on the basis of closing sale prices of the portfolio securities on the previous day; and offered by the distributor at asset value plus a loading charge of approximately 9% of the net asset value.[213] Shares were repurchased by the fund from surplus, when legally available, at asset value computed as of the day shares were tendered for redemption.[214]

The 5% ten-year convertible secured debentures of Affiliated Fund, Inc., were subject to call by the trustee, could be converted by the holder into common stock under certain conditions, or could be tendered to the trustee for liquidation at the option of the holder.[215] The conversion price was equal to twice the average net asset value of the fund's common-stock shares during the calendar year in which the surrendered debentures had been issued.[216] The certificate of incorporation permitted debentures to be issued or to remain outstanding only if the annual yield of all of the corporate assets was 2½% per annum or more and the percentage ratio of such debentures to total assets was limited within a range of from 15% to 66%, in proportion to annual yields ranging from 2½% to 5% or more.[217]

By the terms of the trust agreement, at the time of authentication of additional debentures, property of the investment company held by the trustee had to possess a value of at least 150% of the principal amount of the debentures presently to be outstanding and annual aggregate income on the deposited property had to be at least 150% of annual interest requirements of all debentures.[218] The investment company agreed to keep deposited property equal to a value of at least 125% of all debentures and 125% of annual interest requirements of all debentures.[219] The trustee was instructed to redeem by lot such principal amount of debentures as was necessary to maintain the required ratio.[220]

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[209] Reply to the Commission's questionnaire for Affiliated Fund, Inc., Pt. I.
[210] Ibid.
[211] Ibid.
[212] Ibid.
[213] Op. cit. supra, note 209, Pt. I.
[214] Ibid.
[215] Ibid. Debentures could be converted into common stock at the option of the holder up to the tenth day prior to redemption or maturity.
[216] Op. cit. supra, note 209, Pt. I.
[217] Ibid.
[218] Ibid.
[219] Ibid.
[220] Ibid

In addition to the foregoing, debentures could be tendered to the trustee for liquidation at the option of the holders.[221] Although this right was not granted in the indenture, by resolution of the board of directors a holder could receive 95% of the debenture's principal amount if tendered during the calendar year in which it was issued or the succeeding year; 95½% if tendered during the next succeeding year; and ½% more for each succeeding year thereafter.[222]

George D. Cherry, trust officer of the First National Bank of Jersey City, New Jersey, which served as trustee for Affiliated Fund, Inc., testified that if the value of the assets of the fund shrunk to the touch-off point on the debentures, portfolio securities would have to be sold and debentures called until the necessary ratio of 125% of assets to principal amount of debentures was reestablished.[223] If the touch-off point was reached, for every $1,000 of capital stock which the company was required to purchase upon tender for redemption, assuming no change in the market value of the assets of the investment company, the company would be required to repurchase $4,000 principal amount of debentures. Mr. Cherry testified in this connection as follows: [224]

Q. * * * suppose the assets amount to $125,000 and suppose your debentures amount to $100,000 which brings that right to the touch-off point, just over the line; let us assume that the market is stable and you do not have to consider any further market shrinkage, so as to make the thing more simple. Now, a stockholder comes in, we will say, with $1,000 worth of stock in the Fund, and either directly through you or through the corporation surrenders his $1,000 at its liquidating value for redemption. Would you mind describing just what would be involved and what action you would thereupon take?

A. We would take this action: after following the procedure required by the trust agreement for the redemption of this stock, we would at the significant time, which I am assuming is the time that you mentioned, we would complete that transaction. That would immediately put it below the 125-percent mark. Then we would immediately proceed in the usual course to sell, to bring it up above that mark, because our bank as trustee has always contemplated the various functions of this trust as a separate and distinct function, and the fact that one particular or phase of the set-up is, we may say, bordering on the border line which might cause us to do other duties, nevertheless that should not affect in any way the privilege which is accorded to other individuals in regard to their holdings. It comes down to a very practical operation under the circumstances as we view it.

Q. In other words no matter what the actual status of the fund is as far as assets are concerned, when a stockholder comes in and asks for his funds upon redemption, he is bound to receive whatever liquidating value his shares are worth, irrespective of all other considerations?

A. That is the attitude we seek to maintain.

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Q. So that every time in this hypothetical case, $1,000 of stock comes in for redemption, still assuming market stability, you have to redeem $4,000 of debentures and thereby reduce your fund by the net figure of $5,000; is that not a fact?

A. That seems to be correct to me.

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[221] Ibid.

[222] Ibid. The investment company received 95% of the face amount of the debentures at the time of sale. (Ibid.)

[223] Public Examination, Affiliated Fund, Inc., at 18336. See discussion, supra, concerning the liquidation of portfolio securities.

[224] Id., at 18338, 18341.

The net effect of this senior security issue in the case of Affiliated Fund, Inc. was to accentuate rather than to diminish the selling and management problems arising in the ordinary type of open-end investment company. Thus, one method of overcoming the diminution in the size of the fund by the sale of portfolio securities to meet redemptions, was to increase the sale of stock and so bolster up the assets of the fund by securing additional cash with which to pay retiring stock and bondholders.[225]

The Equity Companies of Incorporated Investors

To stimulate the sale of the stock of Incorporated Investors by taking advantage of the speculative fervor then prevalent, three investment companies—United Equities, Inc. (organized April 17, 1928), Incorporated Equities (formed September 24, 1928), and Equity Investors, Inc. (created June 12, 1929, and name changed July 19, 1929, to Second Incorporated Equities)—[226] were formed to facilitate the purchase by the public of Incorporated Investors stock. These companies were in effect speculative margin accounts in Incorporated Investors stock by reason of funds raised by bank loans and a bond issue collateralized solely with the shares of Incorporated Investors.[227]

William A. Parker, president of Incorporated Investors, describing the sponsorship and the formation of the first of these Equity companies, testified: [228]

A. In the year 1928, speculation was the rule rather than the exception. Every Tom, Dick, and Harry in the country was speculating. That spirit was extended through not only the people who bought United States Steel and General Motors, but went down through the people who were purchasers of investment trust shares, to borrow against those shares to buy additional shares, thereby in their hopes and dreams, at least giving them a chance to make a great deal more money. At that time, it was often the case, if not—yes, I will say often the case, that they would borrow up to 75 percent of the value of whatever shares they bought, to buy additional shares.

At this time, many of our stockholders, and many of our dealers, or perhaps, I should say several of our dealers, we didn't have many at that time, came to us and asked us to help them with the banks, and give them some help with the banks, so that it would be easier for them to borrow against our shares, and speculate in our shares.

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[225] Id., at 18349. See also Ch. V of this part of the report. Andrew J. Lord, president of Affiliated Fund, Inc., in a letter dated May 26, 1937, to one of the directors, expressed some uncertainty as to the continuing advantages of leverage (id., at 18386):

> It seems to me fundamental that unless we have a strong conviction that the trend of the stock market is upward for the next two or three years, we have no moral right to continue Affiliated Fund on its present set-up. We are borrowing money at a high rate of interest in the expectation of being able to use that money to advantage in the stock market. If this premise is wrong, then our whole basis of operation is wrong. But at this stage of our industrial recovery we will find few people who will argue against the position of the upward trend for a long time.
>
> * * * * * * *
>
> In fact, I think you know it is my thought that at some time within the next two or three years we should voluntarily call all outstanding debentures, even though such action will result in a substantial loss of management fees.

[226] Derived from supplementary information supplied the Commission for Incorporated Investors.

[227] Op. cit. supra, note 84, at 2653.

[228] Id., at 2646.

Well, we told them that we did not want them to do that and we advised them, and the demand went on and on, and finally reached the point where one of our dealers said that if we weren't going to do it, that he would do it, that he was going to form a company which we will call an Equity company, because we understand what it means, to buy shares of Incorporated Investors and borrow against them.

We tried to dissuade him at first; however, he persisted in that, and at that point we felt that if he was going to do it, it would be perhaps wiser if we at least joined with him in the thing, to see that it was run properly.

We did not like the idea of an independent dealer or group of dealers forming a speculative company in our shares.

So to our sorrow, we joined with this dealer, in forming the first equity company.

Q. Didn't you feel that you were letting your name, and you lent your sponsorship, and the name of the Incorporated Investors, and of yourselves as sponsors, to the backing of this Equity company, which you apparently didn't approve of?

A. We didn't consider that we were doing that, but it may have been stupid of us.

Q. And you helped organize it, and the actual organization was undertaken by you, wasn't it?

A. Yes. Well, I think that even that is perhaps giving a false impression. The dealer with whom—or of whom I speak, did most of the organizing, and we went along with him to see that it was formed according to or along lines that we were willing to go along with, but most of the work connected with it was done by the gentleman I speak of.

The sponsor-distributors of Incorporated Investors were also directly interested in the Equity companies and the distribution of their securities. These sponsors therefore stood to profit not only from the sales of the shares of the Equity companies themselves but also from the increased sales of Incorporated Investors.[229] The possibility of distribution profits was further increased by the practice of dealers switching investors from the open-end investment company into the Equity companies, as was indicated by the testimony of Mr. Parker:[230]

Q. I just want to take up a few more results of this trust. In certain instances your dealers switched their customers who had bought Incorporated Investors into these equities companies, didn't they?

A. We have no direct knowledge of that.

Q. You know that was done.

A. I am confident that in cases it was done.

That these Equity companies, as a market for the stock of Incorporated Investors, were important is indicated by the fact that at September 30, 1929, approximately 45% of the outstanding shares of the open-end investment company were held by these three Equity companies.[231] In addition, any increase in the size of the fund of Incorporated Investors increased the size of the management fees of these sponsor-distributors.[232]

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[229] Id., at 2650–1.

[230] Id., at 2658.

[231] Op. cit. supra, note 226. These Equity companies possessed a combined paid-in capital of about $12,000,000. (Ibid.)

[232] Op. cit. supra, note 84, at 2654. These Equity companies paid $7,500 per year to Incorporated Investors for expenses, rent, and management. (Id., at 2659.)

These companies were admittedly speculations looking to appreciation of capital, and cash dividends paid on Incorporated Investors stock were insufficient to cover the carrying charges of the Equity companies.[233] Mr. Parker stated that no claim was ever made that such carrying charges would be earned: [234]

Q. Taking this figure of $915.65 which is left after deducting commissions, we have calculated it out that it means that the Incorporated Investors stock in these companies would have to earn 4.5 percent in order to sustain the carrying charges alone. As a matter of fact, in 1928 the cash dividends paid by Incorporated Investors amounted only to a little over one percent and in 1929 a little over 2 percent, so that the cash dividends were not sufficient to pay the carrying charges of these Equity companies. This brings out a fact which I want to bring out in one other way, that the carrying charges were greater than the amount of money coming in and they had to depend upon an increase in capital in order to avoid being eaten up by their carrying charges; that is correct?

A. That is correct. Might I add at this point that that was the avowed intention of the company. No pretense was made that carrying charges would necessarily be earned. They were frankly a speculation, looking to appreciation of capital.

Q. To put it another way, out of that thousand dollars which was invested, if we assume that the stocks in the portfolio of Incorporated did not go up at all, there will be remaining at the end of the year $875 out of the $1,000 after deducting all charges?

A. There would have remained, if they had not gone up.

* * * * * * *

Q. That is another way of stating that there had to be about a 15-percent capital appreciation in these Equity companies in order to maintain their capital intact?

A. Well, I have no means of checking your figures, but I will assume they are correct.

For every dollar invested in the Equity companies another dollar was borrowed and the two dollars would be used to purchase stock of Incorporated Investors, which was used as collateral.[235] Appreciation in the price of the stock of Incorporated Investors made available additional collateral upon which more funds could be borrowed to buy additional Incorporated Investors stock.[236]

The effects of this pyramided leverage structure were evidenced by the following situation. Second Incorporated Equities had pledged 129,000 shares of Incorporated Investors stock to secure its bond issue of $5,000,000.[237] With the market break in October 1929, this stock depreciated to such an extent that the trustee for the bonds declared the bonds due and payable.[238] This substantial block of stock of Incorporated Investors held by Second Incorporated Equities was presented for redemption, creating a situation not unlike a "run" on a bank. In order to raise cash to meet this redemption demand Incor-

[233] Id., at 2652.

[234] Ibid.

[235] Id., at 2653.

[236] Id., at 2653–4. The first two Equity companies utilized such funds to purchase more Incorporated Investors stock. The third company was formed too close to the market break of October 1929 to have much opportunity to utilize such a procedure.

[237] Op. cit. supra, note 84, at 2662.

[238] Ibid.

porated Investors had either to sell its underlying portfolio securities or borrow the necessary funds. On November 13, 1929, it was determined to borrow from the banks sufficient funds to meet this emergency.[239] By such borrowings, Incorporated Investors, an open-end company, became in effect a leverage company.

United Equities, Inc., Incorporated Equities, Inc., and Second Incorporated Equities were on June 14, 1930, consolidated into one corporation, Consolidated Equities, Inc.[240] Although none of the three original Equity companies were of the open-end type, Consolidated Equities, after August 31, 1935, agreed to purchase its outstanding shares at asset value less 5%.[241] This open-end provision operated only with respect to repurchases and new shares were not offered under a continuous selling campaign.[242]

As pointed out above, the earning capacity of the three predecessor companies had been insufficient to meet their fixed charges. Meanwhile, depreciation in market value of its assets and funds disbursed upon redemptions further diminished the size of the investment company so that its net assets, which reached a peak of $19,000,000 in 1929, declined to a low of less than $500,000 at the end of 1935.[243]

e. Advertising Methods

Considerable effort and money were expended by open-end investment companies and by their principal distributors on newspaper and periodical advertising, radio programs, house organs, pamphlets, and circulars, and other general merchandising activities. This material was prepared by the principal distributor and was characterized by its promotional appeal rather than its informative value.

The Parker Corporation during the years 1930 and 1931 conducted radio broadcasts, and the program was linked with its book, "Famous Fortunes."[244] William A. Parker testified as follows:[245]

A. The psychology behind the stories in the series of broadcasts, which again came out in the book, was the background of ownership growth. It was the story of the Famous Fortunes in this country—du Pont, Rockefeller, Astors, and so on, whose wealth had come through ownership rather than through the lending of money; in other words, the common stock theory as opposed to the bond theory. It was the background supporting the common stock theory.

Q. So you think the life of John D. Rockefeller, starting out in the oil industry, is in support of the common stock theory, and, therefore, of investing in Incorporated Investors?

A. I certainly do.[246]

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[239] Id., at 2665.

[240] Op. cit. supra, note 226.

[241] Ibid.

[242] Ibid.

[243] Id., at 2649–50. Mr. Parker testified that Consolidated Equities, Inc., was being operated only "out of a sense of responsibility to the shareholders". (Id., at 2659–60.)

[244] Op. cit. supra, note 226.

[245] Op. cit. supra, note 84, at 2569.

[246] The broadcast opened with a bugle call and was followed by an announcement substantially as follows (op. cit. supra, note 226):

> This program comes to you through the courtesy of the Parker Corporation, general distributors of Incorporated Investors, 60 State Street, Boston.
> Incorporated Investors is one of the largest and oldest of the Boston investment trusts. Shares may be purchased through the Parker Corporation or through dealers in principal cities.

A similar sort of radio program was broadcast under the auspices of Distributors Group, Inc., sponsors of an open-end investment company known as Group Securities, Inc., and a series of fixed trusts known as North American Trust Shares. John S. Myers of the sponsor company described these broadcasts as follows: [247]

Q. I have some of your advertisements and also you have a radio program entitled "Fortune Builders" in which you attempted to stimulate interest in the person of founders of great fortune.

A. No; the radio campaign called "Fortune Building" consisted of a biography given with the permission of the heads of the companies represented in various portfolios. In each instance the biography was submitted to the gentleman to be discussed and had his or his representative's approval and together with the program it was put on the air.

The Parker Corporation, principal distributor for Incorporated Investors, published a regular monthly sheet or "house organ" entitled "The Incorporated Investor," [248] which was circulated among dealers, who apparently used this material in their sales promotion of Incorporated Investors stock. These circulars were supplemented by prospectuses and newspaper advertisements and were all part of an active selling campaign.[249]

Massachusetts Distributors, Inc., which handled the distribution of Massachusetts Investors Trust but was not affiliated with the investment company,[250] published a house organ known as "Brevets." Dr. Sprague, member of the Advisory Board, testified with respect to the investment company's responsibility for the sales literature employed as follows: [251]

A. Well, I will say this, that it is always exceedingly difficult to hold down the salesmen of any product whatever; that I think it is highly desirable that the form of literature sent out by the selling house be placed before the trustees and the advisory board before it goes out.

Q. All of it, Mr. Sprague?

A. All of it.

Q. So that you would feel some duty in respect of the advertising of these shares?

A. I think so, and there have been two or three instances in recent years in which questions have been raised regarding some things which have been said about the trust.

Q. You mean, rather oral representation, than written?

A. Some one or two things in some of the literature. They have a weekly, a little sheet, which is apt to contain things which may be apt to make one's hair curl a little bit.

Q. That is published by the distributors?

A. Yes.

Q. And circulated rather widely?

A. Among the dealers.

The use of spreads in newspapers and periodicals probably constituted the bulk of the advertising done by open-end management invest-

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[247] Public Examination, Distributors Group, Inc., at 10496.
[248] Op. cit. supra, note 5, Pt. I.
[249] Ibid., and op. cit. supra, note 84, at 2570–2.
[250] Op. cit. supra, note 63, at 2404.
[251] Id., at 2428.

ment companies, by their sponsors, distributors, and dealers. For example, John S. Myers of Distributors Group, Inc., gave some indication as to the amount of this type of advertising done by that firm: [252]

A. Our advertising was very substantial.

Q. What was the nature of your advertising generally?

A. Newspapers all over the country. I believe we have a list of the advertising which used to go to probably 75 newspapers in the larger centers where we used to run periodic advertising, magazines of national character, such as Collier's, Literary Digest, Time, and we also put on for a period of 13 weeks a radio campaign in 1931.

The widespread nature of the newspaper campaigns is illustrated by the variety of media used by the Parker Corporation in selling the shares of Incorporated Investors. This list contained 17 widely scattered daily newspapers, three financial dailies, two financial weeklies, and two magazines dealing with current events.[253] In addition, this distributor attempted to appeal to the investor's psychology through the use of such catch-phrases as—

The Foundation for To-morrow's Profits.
Management Stewardship.
Day always Follows Night.
Safeguards to the Investor.
Income that has not Failed.[254]

Hugh Bullock, when examined upon one of the circulars used, testified: [255]

Q. * * * I notice you have a picture here on one page of the Bank of England, and on the next page of No. 1 Wall Street. I take it that that is put in to suggest stability?

A. No, frankly, it is put in to break up the reading matter so people will read anything.

Q. But don't you think there is some psychological connection? One Wall Street is your office, isn't it?

A. Yes. If I must explain, I will be very glad to. Some friends of ours for several years had been featuring the State House in Boston. We thought we would go them one better.

The cost of advertising often constituted a substantial part of the operating expenses of the principal distributor. For example, expenses for advertising and literature incurred by Calvin Bullock, as distributor for Dividend Shares, Inc., totaled $104,523 from 1932 to December 31, 1935, or 37% of the total selling expenses of the principal distributor, exclusive of branch managers' and salesmen's compensation and expenses.[256]

In the case of Bullock Fund, Ltd., another open-end investment company of the Calvin Bullock group, the cost of advertising and literature constituted 59% of total selling expense for that company,

[252] Op. cit. supra, note 247, at 10494.
[253] Op. cit. supra, note 226.
[254] Op. cit. supra, note 5, Pt. I.
[255] Op. cit. supra, note 54, at 4231.
[256] Derived from supplementary information supplied the Commission for Bullock Fund, Ltd.

exclusive of branch managers' and salesmen's compensation and expenses, for the period 1932 through 1935.[257]

During the 9-year period from 1927 to 1935, inclusive, the Parker Corporation spent approximately $265,000 for advertising and sales promotion,[258] in addition to about $7,200 on radio broadcasting.[259] These expenditures represented about ¼ of 1% of the total dollar amount of sales of the shares of this investment company to the public or 19% of the total expenses of the principal distributor, exclusive of salaries, or about 34% of total expenses of the principal distributor, exclusive of both salaries and commissions. Excepting salaries and commissions, the expenditures for advertising and sales promotion constituted the largest single item of the total operating cost of the distributor corporation.[260] Additional expenses of this character included payment of salaries to persons within the organization preparing such material. Since the selling loads on open-end company shares were computed to cover the expenses of selling, investors were in fact financing the advertising and other sales promotional activities of these distributors.

D. Problems in Connection With the Mechanical Operation of the Open-End System of Sales and Repurchases

1. RANGE OF POTENTIAL DISTRIBUTION AND TRADING PROFIT (T. I. S. MANAGEMENT CORPORATION)

In addition to the multiple and hidden loads paid by purchasers of open-end investment company securities,[261] a variety of other possible distribution and trading profits to distributors and dealers existed. These profits, which were directly or indirectly borne by the investors, had not ordinarily been anticipated by or disclosed to the purchasers of shares and varied with the machinery devised for sales and redemptions in individual cases.

Illustrative of such hidden loads is the case of T. I. S. Management Corporation, sponsor and depositor of Trusteed Industry Shares, an open-end investment trust of the restricted management type. The effectiveness of the registration statements filed by T. I. S. Management Corporation under the Securities Act of 1933 was suspended by the Commission on February 25, 1938, pursuant to a stop order proceeding under Section 8 (d) of that Act. The deficiencies in these registration statements resulted "* * * from the registrant's failure to disclose its practice of trading for its own accounts in the registered shares in connection with their distribution and the full extent of the profits which it had thus realized at the expense of the trust and the shareholders." [262] The basic deficiencies and inequities of these practices, for which disclosure has not

[257] Ibid.

[258] Op. cit. supra, note 226.

[259] Ibid.

[260] Ibid.

[261] See supra, p. 813.

[262] Securities Act of 1933, Release No. 1689, February 25, 1938, *In the Matter of T. I. S. Management Corporation,* 3 S. E. C. 174 (1938).

provided a complete or effective remedy, will be discussed in the succeeding subsections hereof.

The shares of Trusteed Industry Shares, an open-end investment trust of the restricted management type created under a trust agreement dated April 1, 1933, were first effectively registered under the Securities Act of 1933 as of April 15, 1935.[263] This trust agreement was amended October 1, 1936, to comply with Section 48 (e) of the Revenue Act of 1936, so that Trusteed Industry Shares might attain the status of a "mutual investment company."[264] Shareholders of record could at any time tender all or any part of their shares to the Trustee for redemption and receive in cash the net asset value of these shares less one-half cent a share conversion fee.[265]

T. I. S. Management Corporation was incorporated January 1, 1935, under the laws of New Jersey to manage and distribute Trusteed Industry Shares.[266] The depositor agreement between Trusteed Industry Shares and Affiliated Management, Inc. was acquired by T. I. S. Management Corporation on January 24, 1935.[267]

T. I. S. Management Corporation, as principal, purchased the shares of the open-end trust, Trusteed Industry Shares, and then resold these shares to dealers through T. I. S. Distributors Company, the depositor's wholesale representative, and to various installment investment plans which used this trust's shares as the security underlying the installment certificates.[268] Of the 9½% load or premium added to the basic price of shares of the Trusteed Industry Shares by the principal distributor, dealers received 6% and T. I. S. Distributors Company received 2%. In cases where the trust shares were sold to the sponsors or distributors of monthly installment plans the distributor of the installment certificate received 8% of the load on the trust share and the principal distributor of the trust share retained the balance of the load.[269]

Although the trust agreement provided for the method of computing the price at which trust shares were to be issued by the trust, the agreement did not specify the price and conditions at which these shares were to be sold by the distributor to the public.[270] When examined on this lack of control, F. D. Crosby of T. I. S. Management Corporation testified:[271]

Q. In other words, when you buy trust shares from the trust, you buy them at the price computed in the trust indenture, is that so?

A. That is correct.

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[263] The set-up of Trusteed Industry Shares in some respects resembled a fixed or semi-fixed investment trust.

[264] Registration Statement, T. I. S. Management Corporation, File No. 2–3485–1–2 (Prospectus dated November 29. 1937, pp. 3, 6, 11).

[265] A minimum fee was charged of either 3% of the value of the shares being converted or $1.00, whichever was lower. (Id., at 5.)

[266] Public Examination pursuant to stop order, T. I. S. Management Corporation, Commission's Exhibit No. 14 (p. 9).

[267] Op. cit. supra, note 264 (Prospectus dated Nov. 29, 1937, p. 10).

[268] Ibid.

[269] Ibid. In addition to this portion of the load on the underlying investment trust share, the distributor of the installment investment plan certificates received an additional load of approximately 10% on the installment certificate.

[270] Op. cit. supra, note 262, at 2.

[271] Op. cit. supra, note 266, at 52.

Q. And whenever you sell trust shares, you could, under the trust indenture, sell them at whatever price you pleased.

A. That is correct.

Q. And you have the right and exclusive right to set the selling price?

A. That is correct.

Q. In other words, if anybody wants to buy Trusteed Industry Shares from you, they have to buy at your price.

A. That is correct.

There were four ways, undisclosed to the public, by which the distributor of the trust shares increased its profits over the published load of 9½% per share: [272]

(1) profits derived from the difference between the basic price at which shares were issued by the trust to the distributor and the basic price at which these shares were sold by the distributor to the public;

(2) "breakage profits" arising from fixing the price of the shares to the public at the next full cent when fractions were involved;

(3) profits resulting from the computation of the published load upon the distributor's basic price instead of the trust's basic price; and

(4) profits derived from trading against the trust in the shares of the trust, both by long positions and short positions.

All of these factors were material in determining the actual load and the price paid by the investor.

a. Raising the Basic Price

By the terms of the trust agreement, the price paid by T. I. S. Management Corporation, the principal distributor, for shares of Trusteed Industry Shares on any particular day was based on the previous day's closing bid prices on the stock exchange of the portfolio securities of the trust.[273] To the aggregate value of the portfolio securities, based on their previous day's closing bid prices and the cash in the trust, certain brokerage fees, taxes, and accumulated dividends were added. This total was divided by the number of shares of the trust outstanding in order to determine the asset value per share of the outstanding trust shares which was the basic price per share to the principal distributor.[274] However, the distributor computed the basic price of the shares to the public not on the basis of the closing bid prices of the portfolio securities of the trust but on the previous day's closing sale prices of these portfolio securities.[275] Since the bid price was never higher than the closing sales price and almost invariably the bid price was lower than the last sales price, the principal distributor had as one source of profit the aggregate of the differences between the bid price and sales price on each of the portfolio securities. This was illustrated by the testimony of Mr. Crosby, as follows: [276]

Q. And at the time you filed the three registration statements, the depositor, meaning T. I. S. Management Corporation, was entitled to the difference between the closing bid price and the closing sales price.

A. That is correct.

[272] Op. cit. supra, note 262, at 4.

[273] Op. cit. supra, note 266, at 12.

[274] Ibid.

[275] Ibid.

[276] Id., at 13.

Q. And in every instance wouldn't you say the closing bid price was lower than the closing sales price?

A. That is correct.

Q. So there was at all times an additional source of profit to you as a depositor.

A. That is correct.

b. Rounding Off or "Breakage"

The distributor, after computing the basic price of the open-end investment company shares on the basis of the previous day's closing sales prices of the trust's portfolio securities, added brokerage and tax charges as well as the 9½% premium or load to that valuation as noted above. If a fractional cent resulted from this computation of the resale price of the trust's shares, the distributor raised the price to the next full cent and retained this so-called "breakage" as part of its profits.[277]

For the first 11 months of 1937 the breakage averaged three-tenths of 1% of the daily offering price.[278] The significance of this sum in comparison to the 9½% load depended, of course, upon the market value of the individual share and the volume of sales. The cumulative effect of this factor on the published load is noted in the ensuing section.

c. Increasing the Published Load

Because of the fact that the published load of 9½% was figured on the basic price computed by the distributor the actual load paid by the investor was equal to more than 9½% on the creation value of the shares as issued by the investment trust. Mr. Crosby testified as follows concerning this hidden load:[279]

Q. I think you testified a short while ago, Mr. Crosby, that the load was 9.5 percent, approximately. Is that correct?

A. Based on the closing sales price.

* * * * * * *

Q. What does the load amount to on the creation price?

A. That I don't know offhand.

Q. Approximately.

A. We would probably add ⅞ of 1 percent more to it on the average for the year.

Q. And what would that ⅞ of 1 percent represent?

A. The spread between the closing bid and the closing sale.

Q. And you have the breakage.

A. That is correct.

Q. So instead of 9.5 percent, it would be a figure close to 10 percent; approximately 10 percent.

A. On the closing bid prices.

d. Profits from Riskless Trading in Trust Shares

Another possible source of profit to the distributor or dealer, which was made at the expense of open-end investment companies and their

[277] Id., Commission's Exhibits Nos. 7, 8, and 9.

[278] Op. cit. supra, note 264 (Post-effective amendment filed December 10, 1937).

[279] Op. cit. supra, note 266, at 30.

shareholders was the trading in the shares of the open-end company. For example, T. I. S. Management Corporation, distributor of Trusteed Industry Shares, acted in the capacity of principal in purchasing these shares from the trust and selling them to the public.[280] The distribution practice was to buy shares from the trust at the creation price and then to resell such shares on the basis of closing sales prices to dealers and to five companies which sold installment investment plans with the shares of Trusteed Industry Shares as the underlying security.[281] Because of its right to buy trust shares as principal in such amounts as it desired, the distributor could take long or short positions in these trust shares.

The asset value of the shares or certificates of the company or trust was determined on the basis of the market price of the underlying securities which prevailed at the close of the market on the previous day. The asset value in effect from 10 a. m. Tuesday until 10 a. m. Wednesday, which was, of course, the basis of the retail selling price and of the price to principal distributors and dealers during that time, was determined by the price of the underlying securities at the close (3 p. m.) of Monday's stock market. Similarly, the price of shares or certificates from 10 a. m. Wednesday to 10 a. m. Thursday was based on the market prices of the underlying securities at the close of Tuesday's market. Therefore, after 3 p. m. Tuesday the principal distributor or dealers could determine the price which would be in effect from 10 a. m. Wednesday to 10 a. m. Thursday, and at the same time could take down shares until 10 a. m. Wednesday at a price based on Monday's closing prices.

Sales of shares or certificates by the distributor or by dealers during Tuesday were based on the price effective that day, that is, the price based on Monday's closing quotations for the underlying securities. However, the distributor or dealer did not have to deliver to the customer until several days later so that it was not essential to take down shares or certificates from the company or trust immediately upon confirmation of the public's order at the effective price of that day.

The ability to defer purchases together with the method of selling, permitted the principal distributor and dealers during the period from Tuesday at 3 p. m. to Wednesday at 10 a. m. to choose, without risk, between the price based on Monday's closing quotations and that based on Tuesday's closing quotations. If the market quotations of the underlying securities at the close of Tuesday's market were higher than the prices at the close of Monday's market, then Wednesday's price for the investment company issue would of course be higher than Tuesday's, and the principal distributor or dealer would take down from the company or trust at Tuesday's price and fill the public orders confirmed on Tuesday at that price with the certificates so taken down. In such event no trading profit would be realized by the principal distributor or dealer.

However, if Tuesday's closing market quotations for the underlying securities were lower than Monday's closing prices, then Wednesday's take-down price of the shares or certificates would be lower than that

[280] Id., at 51.

[281] Income Estates of America, Benjamin Franklin Foundation, Lexington Foundation, Liberty Thrift Foundation, National Trustee Fund. (Id., at 18.)

in effect on Tuesday. The principal distributor then would remain short until Tuesday's closing prices became effective on Wednesday and would not take down shares or certificates to fill the orders confirmed to the public on Tuesday until Wednesday. Since in this event the orders confirmed to the public would be on the basis of the higher price prevailing on Tuesday, and since the distributor would take down shares at Wednesday's lower take-down price, the principal distributor or dealers would make a trading profit in addition to their regular spread.

In other words, the securities would be confirmed on Tuesday to the public on the basis of Monday's market prices. The principal distributor or dealer could wait until the close of the market on Tuesday, and at that time could either take down the shares or certificates from the open-end company or trust at a price based on Monday's market prices or could wait until Wednesday to take down shares based on Tuesday's closing prices, which he knew. He, therefore, had the equivalent of a "call" or a "stop loss order" protecting his short position and could choose the lower price and retain for himself any profit resulting from his buying on a lower price basis than was available to the public.

When principal distributors or dealers availed themselves of the profit opportunities inherent in this situation the investment trust or investment company would, instead of receiving the higher of the two prevailing prices for its shares or certificates, receive the lower of these two prices, a process which would constitute a dilution of the equity or interests of the existing shareholders or certificate holders.

Mr. Crosby, when examined concerning the mechanics of taking a short position in the trust shares, testified: [282]

Q. Assume that the closing sales price of the securities in the portfolio made the average price per share of Trusteed Industry Shares that would be offered to the public today $1.20, and assume that the market falls off so that by shortly after three o'clock, at the close of the Stock Exchange, you can exactly calculate what the price will be that will be offered to the public tomorrow, which, say is ten cents lower, $1.10.

A. That would be quite a drop. I would rather make it four cents lower.

Q. Make it $1.15 if you like. Assuming also that you had a fairly constant demand, that orders have come in for 5,000 shares, you would not cover or pull down any shares of the trustee at all?

A. That is correct.

Q. You would go short. Assuming the market fell off again that day so that the next day it would be a $1.10 offering price to the public and you got another 5,000 orders, you still wouldn't cover those shares, and assuming the next day that the price you could immediately calculate went up to $1.15 again, you would cover by 4:30 for ten thousand shares at $1.10, would you not?

A. That is correct.

Mr. Crosby admitted that there was no risk involved in taking such a short position: [283]

Q. And you in no instance incur any risk in that sort of situation, inasmuch as you know what orders you have on hand and you know you don't have to fill those so long as the market is going down.

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[282] Op. cit. supra, note 266, at 31.
[283] Id., at 32.

A. That is correct.

Q. And as soon as the market goes up you can always fill those orders immediately you know the market is going to be higher the next day and realize the maximum profit.

A. That is correct.

The practical application of this riskless trading practice was graphically illustrated by the fact that on or about October 21 or 22, 1937, immediately after the market break of October 19, 1937, T. I. S. Management Corporation purchased 190,000 shares from the trust at depressed prices, with which it covered an existing short position at a substantial profit.[284] Mr. Crosby testified:[285]

Q. In the course of our investigation, Mr. Crosby, it is learned that on or about October 21 or 22 of this year T. I. S. Management Corporation bought 190,000 shares from the trustee. Is that correct?

A. That is, I believe, correct.

Q. And that is shortly after the severe market break of October 19?

A. That is correct.

Q. As I recall it, the purchase price of those shares was about 88¢; is that correct?

A. I don't know that.

Q. It was fairly low.

A. I imagine that is probably correct.

Q. And as a result of that transaction I gather the depositor reaped a substantial profit.

A. That is probably correct.

Q. And at the time of purchase of shares, I assume the depositor corporation had a fairly substantial short position.

A. That is probably correct.

Q. And by being able to purchase these shares at 88¢ approximately, and cover all outstanding orders, the profit naturally would be quite substantial, would it not?

A. I believe so, though I do not know the figure.

Conversely, the distributor or dealer may have assumed a long position in the trust shares in a rising security market. Whereas the assumption of a short position in the trust shares involved no risk on the part of the distributor or dealer, the assumption of a long position did involve a certain element of risk.[286] To make a profit on a long position, the distributor or dealer must have taken down or purchased from the trust a block of trust shares in anticipation of orders from the public at higher prices because of the rising market price.[287] This element of risk was almost entirely eliminated in the case of T. I. S. Management Corporation because the majority of its shares were sold to the five companies offering installment investment plans, which provided a fairly constant demand for shares. The distributor was in a position to gauge with reasonable accuracy in advance the day by day minimum demand for trust shares by these plans.

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[284] Id., at 28–9.

[285] Ibid.

[286] Id., at 34 and 66.

[287] Id., at 24.

With reference to the shares sold to these investment plans, Mr. Crosby stated:[288]

Q. And since there is generally a normally constant demand due to the operation of these deposit plans, etc., you can more or less generally calculate, although there is a certain possibility of error, how much to go long on any given situation?

A. Within reasonable limits; yes.

* * * * * * *

Q. I believe you testified that there was a risk involved in taking a long position.

A. That is correct.

Q. Wouldn't you say that generally the risk was quite insignificant in view of the fairly constant demand for Trust Shares which you say you had created?

A. I would be willing to say that I generally made a profit from long positions, but I would not hazard a guess as to the amount of risk.

Even in the case of the sale of trust shares by dealers it was possible for the distributor to foretell the demand for shares and the long position to assume.[289] Mr. Crosby stated that it was possible for dealers, who sold only about 20% of the shares distributed, to trade against the distributor:[290]

Q. And what is the percentage of shares purchased through dealers; about 20 percent?

A. It is constantly growing, but currently about 20 percent.

Q. In other words, the 80 percent are purchased by thrift funds [installment investment plans] through yourself?

A. That is probably correct.

* * * * * * *

Q. So can't the assumption be made, generally speaking, that you aren't exposing yourself too much to a risk of loss?

A. I am not exposing myself to bankruptcy; no; but I am exposing myself to loss by reason of the fact that dealers can take a position against me; yes. Whether or not there would be a loss is very hard to determine.

T. I. S. Management Corporation exercised no control over its dealers, who also could take long or short positions in the trust shares against their customers' orders.[291] This advantage was sometimes passed on to the investor as a retail selling argument.[292] The distributor even went so far as to notify dealers by telegraph of the existence of the two prices for the trust shares, allegedly to encourage sales of these shares, although the existence of these two prices may also have encouraged dealers to trade against the fund.[293]

The general effect of the distributor and dealers taking positions in trust shares was that the distributor or dealer retained part of the money paid by the purchaser of trust shares which would ordinarily have gone to the investment trust.[294] Thus this practice resulted in a diminution of the equity of existing stockholders in the fund.[295]

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[288] Id., at 66.
[289] Id., at 72.
[290] Id., at 72–3.
[291] Id., at 18.
[292] Id., at 19.
[293] Id., at 18, 19, and 34.
[294] Id., at 20.
[295] Id., at 22.

That these practices were of consequence is indicated by the fact that T. I. S. Management Corporation made a gross profit of approximately $37,000 for the first 9 months of 1937 from these 4 sources: raising the basic price, breakage, increasing the published load, and riskless trading in the trust shares against the trust fund.[296] The effect of these practices is also illustrated by the fact that approximately only 88% of the investor's funds paid for the trust shares actually reached the investment trust,[297] whereas the prospectus for Trusteed Industry Shares stated that the estimated net proceeds to the trust was approximately 91%.[298] The misleading character of this statement in the prospectus was admitted at the public examination.[299] The percentage of gross profits from the distribution of these trust shares amounted to approximately 12%, for the first 9 months of 1937.[300] Mr. Crosby, examined in relation to these practices, testified:[301]

Q. Mr. Crosby, would you say that this was an unusual set-up for an investment trust? Is this a general, typical plan that is followed by most investment trusts in similar activities?

A. Most investment trusts are incorporated and ours is unincorporated, but I would say that taking positions is an accepted practice in the operation of investment trusts.

Q. With the same fore-knowledge of what the price would be the next day?

A. Some have even a greater fore-knowledge than we have.

Q. That is a general practice?

A. Some can wait up until one o'clock on Wednesday to create Monday's close, and twelve o'clock on Wednesday, so they have a longer or greater fore-knowledge of price change than we have.

Q. When this scheme had ample precedent, is that right?

A. I would say it is an accepted practice.

2. TRADING PRACTICES

After the original distribution of the shares of closed-end investment companies, the prices obtainable by shareholders for their shares were essentially open market prices. However, the open-end investment company, because of its continuous sales and redemptions, provided the market for its shares. The investor could always sell to and usually could buy from the open-end investment company. Consequently, the open-end investment company shareholder had no need for an exchange or over-the-counter market, and the supply or demand for the shares of the open-end investment company had little effect (except possibly upon the size of the sales load) upon the price of the shares which was based upon the market price for the underlying portfolio securities.

If the investing public lost confidence in the management of a closed-end investment company, the volume of sales would increase and the

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[296] Op. cit. supra, note 262, at 6. This amount did not include profits made from the short position of the distributor during the declining market subsequent to September 30, 1937. (Op. cit. supra, note 266, at 29.)

[297] Op. cit. supra, note 262, at 6.

[298] Op. cit. supra, note 266, Commission's Exhibit No. 14.

[299] Id., Commission's Exhibits Nos. 7, 8, and 9.

[300] Op. cit. supra, note 262, at 6.

[301] Op. cit. supra, note 266, at 46.

market price would tend to decline. In many instances the closed-end investment company shares sold at a discount—at a market price below asset values. Conversely, confidence in the management of a closed-end investment company might cause the shares to sell at a premium—at a market price above asset value. In an open-end investment company, the shares virtually never sold at a premium or discount since the shares could be sold or purchased at about asset value. The confidence or lack of confidence in the management of open-end investment companies was not, therefore, reflected in premiums or discounts for the open-end investment company shares but rather in increases in sales of shares or increases in redemptions, respectively. An increase in redemptions of shares was usually accompanied by increased selling pressure with higher loading charges to overcome the diminution in the size of the company caused by the redemptions.[302]

a. Maintaining a Market for the Shares of Open-End Investment Companies

Prior to the market break in October 1929 the premiums above asset values commanded by the shares of many closed-end investment companies made the sale of such security issues an easy undertaking. However, during the declining markets following 1929, when such shares customarily sold at discounts below asset values in spite of substantial repurchases by some closed-end investment companies of their own security issues, the successful marketing of new issues of that character was practically impossible. However, the shares of open-end investment companies did not sell at discounts since the shareholders were at all times assured of asset values from the issuing companies and prospective purchasers could not generally buy shares of an open-end investment company except at asset value plus a loading charge above asset value. This right to obtain the approximate asset values of open-end investment company shares at any time assisted the sale of open-end investment company shares during the depression period, and open market operations for the purpose of supporting such sales were not necessary.

The basic market for the shares of open-end investment companies was created and maintained by each open-end investment company for its own shares, usually pursuant to provisions set forth in the charter or trust agreement.[303] In the case of a few open-end investment companies—companies sponsored and managed by investment counsel—distributors and the various selling devices were not utilized. Prospective purchasers, instead of being solicited went directly to the investment company, or the sponsor's investment counsel, if they desired to acquire shares in the open-end investment company. Furthermore, the trust shares could ordinarily be sold by stockholders only to the investment companies from which they were purchased.

Many open-end investment company shares, however, were sold by distributors and dealers who created and maintained active markets of their own in the shares of those companies in which they were

[302] See discussion supra, p. 806.
[303] See supra, pp. 799 et seq.

interested.[304] These secondary markets necessarily were based upon, and ordinarily operated between, the bid and asked quotations set by the open-end investment companies from day to day. Several factors operated to make such distributor markets the active markets for open-end investment company shares. First, in many cases the distributor could act as a principal in the sale and repurchase of shares and trade in such shares for his own account which opened up a source of profit in addition to the loading charge.[305] Second, open-end investment companies would sometimes be authorized to redeem shares only at or near the liquidating value as determined at the close of the next succeeding day to that on which such shares were turned in for redemption. This practice meant that the outgoing stockholder had to wait a day to ascertain the precise amount he could receive for his shares and wait even a longer period for his cash. The dealer or distributor making a market would ordinarily repurchase the shares of the outgoing stockholder and pay cash immediately.[306]

Third, in practically all cases, the principal distributor had the exclusive rights to sell the stock of the open-end investment company and the prospective purchaser was compelled to buy shares from the distributor or his authorized dealers.[307] This, in effect, made the distributor the focal point for the purchase and sale of shares.

Fourth, in at least one case, the distributor had a right to purchase, and did purchase for resale, all trust shares which were tendered.[308] This practice obviated the necessity for disclosing to the shareholders of the company the extent of tenders for redemption and consequently the extent of any loss of confidence of these holders in the management.[309]

b. Trading Against the Load and Matching Orders

A brief outline of the mechanics of handling the sale and repurchase of open-end investment company shares will indicate more fully the opportunities for indirect and hidden profits in addition to the published load. The asset value and the offering price for a share of an open-end investment company varied from day to day and was effective during a set period, usually from 10:00 a. m. one day to 10:00 a. m. the following day. Dealers were notified by the distributor before the daily price change became effective.

In the case of a buying order where both the dealer and distributor acted as agent for the open-end investment company, the procedure for the sale of shares of National Investors Corporation was described as follows by H. Dudley Swim:[310]

> Local dealer's salesman secures order. Prospectus furnished. There is nothing to prevent either customer or dealer (for customer's account) from withhold-

[304] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 241–4.

[305] See T. I. S. Management Corporation, supra, pp. 847 et seq.

[306] The dealer or distributor probably would pay an amount a little less than his estimate of the liquidating value at the close on the following day, unless there were prospects of immediate resale or a rising market. (Op. cit. supra, note 128.)

[307] For discussion of trading of open-end company shares in the "bootleg market" see infra, p. 865.

[308] Op. cit. supra, note 266, at 39.

[309] Id., at 74.

[310] Op. cit. supra, note 102.

ing actual placement of order for [execution] until a day when stock market prices have risen, the order then being executed at that day's offering price which is based on the next preceding day's asset value. When, where, or how the payment is received by the local dealer from his customer is a matter of his determination.

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Dealer communicates order to distributor—usually by telephone or telegraph. Order is not effective until accepted by distributor, and acceptance is subject to distributor's sole discretion.

* * * * * * *

Distributor confirms to Corporation's New Jersey agent by 4:15 p. m. New York business time (12:15 p. m. on a Saturday) all purchases and sales effected up to 4:00 p. m. (12:00 noon on a Saturday). Purchases and sales are not netted but reported separately.

Detailed confirmations are received on following morning showing each dealer's orders against which the distributor has purchased stock from the corporation * * *.

Corporation directs transfer agent to issue stock in names and denominations requisitioned or to be requisitioned by distributor, and deliver such stock to distributor against receipt of payment in current funds. Distributing contract provides that registration instructions must be received from distributor within two full business days after sale, and delivery must be taken against payment within 10 days.

If distributor receives payment at or shortly after receipt of order, stock is registered in name requested by dealer and shipped by distributor to dealer "free." If dealer does not remit payment to distributor, stock is registered in distributor's name or "street name" and shipped by distributor's bank to dealer with draft attached and with open endorsement on certificate. Distributor has arranged with its own bank to handle all "clearances" and to finance the "float" which results from draft-attached shipments.

Dealer handles delivery of stock to his customer.

In cases where the dealer acted as principal and received a buying order, the necessary shares could be furnished from the dealer's inventory, purchased either from some other dealer usually at a discount, from the distributor, or borrowed for delivery if the dealer was short the shares. Similarly, if the dealer were acting as agent in such a transaction and the distributor were acting as principal, shares could be procured by the latter either from its own inventory or the investment company, or borrowed for delivery purposes.

In the first type of transaction, where both dealer and distributor acted as agents in the sale of shares for the open-end investment company, the published loading charged or known premium paid by the investor was returned by the investment company to the principal distributor, who reallowed a certain portion of it to the dealer. For example, the selling agreement between Dividend Shares, Inc., and Calvin Bullock, the distributor, provided for a loading charge of 8⅔% of the offering price.[311] About 5% went to the dealer, who, in turn, reallowed his salesmen 2½% of this amount.[312] Of the remaining 3⅔% retained by the distributor, an amount was given to the wholesaler equal to 1% of what the latter wholesaled in dollar volume.[313]

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[311] Op. cit. supra, note 3, Pt. IX, "Selling agreement of February 28, 1936."

[312] Op. cit. supra, note 54, at 4201.

[313] Ibid.

In the second type of transaction noted above, however, where a dealer acted as principal, the profits on a buying order could be substantially increased. If the dealer held a long position in the shares of the trust at a price equal to current liquidating value and received a buying order which he filled with such shares, he received the full amount of the load, as the distributor was not called upon to furnish the shares. The matching of a selling order with a purchase order also accomplished this result. If the cost of his inventory position of one share was less than current liquidating value, he pocketed this differential plus the load. If the cost of his inventory position was more than the current liquidating value, he still made profits over and above his normal percentage of the load, up to a point where the cost of his inventory position was equal to the wholesale price.

Thus, the dealer on any inventory position always had the full amount of the load with which to hedge. In addition, the dealer could always turn in his inventory to the principal distributor for redemption or resale and receive current asset value. When these opportunities for the dealer were coupled with the operation of the two-price system, discussed hereafter,[314] the result was to place the dealer in a position where he could trade against the underlying fund at no risk to himself.

Opportunities similar to those enjoyed by the dealer were also available to the principal distributor, although more limited in their scope. Inasmuch as the distributor could not secure any more of the load by acting as principal than he could by acting as agent (unless he sold retail), profits on an inventory position could only be derived from a favorable price differential between the cost of inventory and the current asset value of the shares.

As in the case of the dealer, the distributor could utilize that portion of the load retained to hedge his inventory position. Unlike the dealer, however, who could obtain cash from the distributor if he wished to liquidate his inventory, the distributor could not immediately liquidate his inventory position with the investment company, because of the one-day lag usual in determining the redemption price.[315] This factor introduced an element of risk into the distributor's trading position.[316]

Long positions were assumed by the distributor or the dealer in two ways—either by purchasing shares for their own account from the open-end investment company (or sometimes from the distributor in the case of the dealer), or by purchasing shares turned in for redemption. As in the case of a buying order, distributors and dealers acted either as agent or as principal for the retiring stockholder.[317]

[314] See infra, pp. 860 et seq.

[315] On the other hand, Massachusetts Investors Trust repurchased shares at 10 a. m. at the net liquidating value at the previous closing of the Exchange. (Registration Statement, Massachusetts Investors Trust, file No. 2–3512 [Prospectus, December 15, 1937].)
Shares were repurchased by Incorporated Investors at the price as of the day of reacquisition. (Op. cit. supra, note 5, Pt. IX.)

[316] The extent to which the element of risk could be eliminated has already been pointed out above in the case of T. I. S. Management Corporation, supra, pp. 847–54.

[317] The 80% of total repurchases for 39 open-end investment companies and investment trusts for the period 1927–1935 which were made through the distributor as agent did not include shares repurchased by distributors and dealers which were subsequently resold and is, therefore, not an accurate indication of the turnover of shares in the hands of the public. (See supra, p. 809.)

Profits from the repurchase of shares could be secured only if such shares could be resold, either back to the investment company or to prospective investors.[318]

c. Trading Against the Fund

The two-price system has been employed by almost all open-end investment companies,[319] and although it represented an improvement over methods of more infrequent pricing used in the past, it can be operated to the detriment of investors and stockholders.[320]

The prospectus of Dividend Shares, Inc., describes the typical operation of the two-price system as follows: [321]

> The Company's shares are offered for sale by Calvin Bullock (a New York joint-stock association), the Distributor, at a price equivalent to their approximate liquidating value (as above described) determined as of the close of business on the last business day on which the New York Stock Exchange was open next preceding the date on which a subscription is accepted, plus a premium of 8⅔% of offering price (i. e., slightly less than 9½% of liquidating value).
>
> *   *   *   *   *   *   *
>
> Calvin Bullock's offering price, on any day, based on the previous business day's liquidating value as aforesaid, remains in effect until 12:00 p. m. (or such earlier time as Calvin Bullock may fix from time to time), New York Business Time, on each day shares are offered. A tentative estimate of the next day's offering price is available to dealers at Calvin Bullock's offices approximately one and one-half hours after the close of the New York Stock Exchange on each business day, and dealers are advised of such tentative estimate at that time, principally by mail and telephone. Since a tentative estimate of the new offering price is known while the previous offering price is still in effect, dealers and investors may defer purchasing shares at the then effective price when it appears that the price to become effective the next business day will be lower, and, conversely, may purchase shares at the then effective price when it is known that the price to become effective the next day will be higher. All such purchasers thus have and have had the opportunity of placing orders after the time when there has been an increase in the asset value of the Company's shares and before the higher liquidating value becomes effective, thereby securing the advantage of the lower public offering price then in effect.

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[318] Mr. Crosby admitted with reference to T. I. S. Management Corporation that the differential between the repurchase price of such shares and the current value of new shares issued by the Trust constituted a source of profit to the distributors. (Op. cit. supra, note 266, at 39.)

[319] Four exceptions were: Axe-Houghton Fund A, Inc.; Axe-Houghton Fund B, Inc.; Institutional Securities, Limited; and Corporate Investors, Limited. Massachusetts Investors Trust, for example, prior to January 1, 1928, changed its price every 2 weeks and between July 9, 1931, and February 1, 1932, an inventory was taken whenever the Dow-Jones Industrial Averages changed 4 points either way from the previous inventory, provided, however, that in any event a new inventory should be taken every 7 days. Since February 1, 1932, the net asset value has been redetermined on an appraisal basis every 24 hours. (Reply to the Commission's questionnaire for Massachusetts Investors Trust, Pt. IX.)

[320] See T. I. S. Management Corporation supra, pp. 847 et seq.

[321] Registration Statement, Dividend Shares, Inc., File No. 2–3588 (Prospectus, July 23, 1938).

(1) RISKLESS TRADING PROFITS FOR THE DEALER

From the point of view of the dealer acting as a principal, the maintenance of the two-price system made it posible for him to take long or short positions in the shares of open-end investment companies and investment trusts at no substantial risk to himself. The fact that riskless trading operations have been indulged in by dealers for open-end investment companies was demonstrated in the case of T. I. S. Management Corporation.[322] In the preceding section it was pointed out how dealers could make extra profits from the resale of shares turned in for redemption. These operations were put on a riskless basis by the two-price system.

In connection with such trading there has been the added advantage afforded dealers for investment companies located in the eastern part of the country to sell such shares in the western part of the country because of the difference in time. The west coast dealer has the advantage of a business day that is three hours later than that in the east. Thus, if the next day's liquidating value for the shares of an open-end investment company is determined in New York at 4:00 p. m. New York Time, it is only 1:00 p. m. West Coast Time, and the dealer has all the afternoon to trade against the two prices.

A dealer in the shares of an open-end investment company who assumed a long position in the face of a rising market could liquidate such a position, if necessary, at no risk to himself and usually at a profit, even in the face of a declining market. The bid and asked prices for the shares of one investment company for the three days April 1, 2, 3, of 1935 were as follows:[323]

	Bid	*Asked*
April 1, 1935	$18.08	$19.65
April 2, 1935	18.14	19.72
April 3, 1935	18.06	19.63

The offering price of $19.65 for April 1 had been determined on the basis of the preceding day's asset value. The offering price of $19.65 for April 1 remained effective from 10:00 a. m. the morning of April 1 to 10:00 a. m. the morning of April 2. The dealer, however, knew after the close of the securities markets on April 1, that the price the following day would be higher. Thus, by taking a long position he could hope to profit from this differential on all shares sold at the higher price.

In order to take a long position shares could be purchased by the dealer from the distributor at a discount of 3½% from the offering price, from other dealers at the offering price less 1%, or perhaps from retiring stockholders at the bid price of the distributor. In terms of the prices quoted for April 1 above, the dealer could have purchased a share from the distributor for $18.96 ($19.65 less 3½%), from another member of the selling group for $19.45 ($19.65 less 1%), or perhaps from a retiring stockholder for $18.08 (the distributor's bid price). The differential in the three prices represented the premium which the dealer had to pay above the distributor's bid price in order to secure a share.

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[322] See supra, pp. 847 et seq.

[323] The asked price was the offering price to the public; the bid price represented what the distributor would pay on redemption.

The method by which dealers could make profits from such an inventory position and use the load as a hedge against a decline in price has already been described in the preceding subsection.[324] Although such trading operations were speculative in their nature, the risk in such a position could sometimes be entirely eliminated by the dealer if he purchased his long position at the distributor's bid price from a retiring stockholder. This required a combination of three things: the fact that the distributor customarily maintained an independent market,[325] the fact that the dealer paid no premium on the shares purchased, and the fact that the dealer knew in advance the next day's price.

For example, suppose the dealer purchased a share from a retiring stockholder at the distributor's bid price of $18.08 on April 1 in anticipation of the known price rise on April 2. A buying order did not materialize on April 2 and the dealer was faced with a known decline in the price on April 3. To avoid any chance of loss the dealer could liquidate his share with the distributor at a price of $18.14 on April 2 after he had become aware of the fact that the next day's price would be lower. Thus, not only was no risk taken by assuming this long position, but the dealer made a profit of $0.06 in the face of a declining market.

This profit received on liquidation could be increased considerably in a case where the market steadily rose over a period of days. Dealers could take such long positions, hold them as long as the market rose, and then, when they were apprised that the next effective price would be lower, redeem the shares with the distributor and secure a riskless profit. At no point did the public purchaser enter into such a situation; the dealer was trading against the distributor and ultimately against the underlying fund.[326] The investor could not readily indulge in a similar practice because he had to pay a premium over asset or liquidating value, a premium which was lost upon redemption.[327]

As in the case of the long position noted above, the dealer, as a result of the operation of the two-price system, could also make riskless profits from a short position. In this situation the dealer would know that the market had declined, and, because of the fact that actual delivery of shares could be delayed, orders to customers could be confirmed at the higher price and covered at the lower price. Unlike a long position against which orders were anticipated at a higher price, the short position of the dealer involved the confirmation of orders for shares which the dealer did not possess but which he expected to procure at a price lower than that at which he had confirmed such orders to his customers.

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[324] See supra, p. 857.

[325] If the investment company repurchased at current prices the distributor's market was unnecessary for the dealer's purposes. See supra, p. 856, and op. cit. supra, note 128.)

[326] In some cases the public received the benefit of the two-price differential. (See supra, p. 854, and op. cit. supra, note 128.)

[327] In Massachusetts Investors Trust, however, officers and employees of the Trust and of the distributor could purchase shares at liquidating value "for investment". (Registration Statement, Massachusetts Investors Trust, file No. 2–3512 [Prospectus, January 16, 1929].)

Taking the same case again, for the sake of illustration, the published bid and asked prices for the 2 days, February 20–21, 1935, were as follows:

	Bid	Asked
February 20, 1935	$19.02	$20.67
February 21, 1935	18.96	20.61

Suppose that on February 20 the dealer received a buying order which he confirmed at the offering price of $20.67. After the close of the securities markets on February 20, he was apprised that the next effective offering price would be still lower, namely, $20.61 for February 21. Instead of placing an order with the distributor at $20.67 so as to cover his short position of February 20, he delayed placement of the order until after 10:00 a. m. the morning of February 21, when the new low price became effective. Thus, the investor paid $20.67 for his share and the dealer secured the benefit of the lower price the next day. No risk accrued to the dealer in such a transaction because of his knowledge of the next effective offering price before he had to place the order with the distributor.[328] In the case of a steadily declining market, the dealer could have maintained his short position until the price turned upward, limited only by his customer's demand for delivery.[329]

(2) RISKLESS TRADING PROFITS FOR THE PRINCIPAL DISTRIBUTOR

If the distributor for an open-end investment company were to take down shares[330] in anticipation of orders to be received at a higher price, an element of risk and potential loss was always present unless future orders could be accurately forecast, as in the case of T. I. S. Management Corporation,[331] or where such a position could be liquidated with the open-end investment company at the purchase price or above.[332] Whereas the long position of the dealer could always be liquidated with the distributor at the latter's current bid price, the liquidation of the distributor's long position could only be effected through the investment company and often entailed at least a 24-hour delay for the determination of the redemption price.[333] However, the anomaly is sometimes presented in a rising market of an investment company offering its shares on the basis of asset value computed on the previous day's market close, or at a price lower than the redemption or bid price of the shares based upon the same day's market close and therefore higher than the current offering price.

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[328] A variation of this type of transaction would be provided where a dealer could conceivably sell shares short to the distributor knowing that his position could be covered through the repurchase of shares from retiring stockholders at a lower price the following day.

[329] Dealers could often borrow stock for delivery if necessary.

[330] Of course the assumption of any position depended upon whether the distributor could act as a principal. (See supra, pp. 856–7.)

[331] See supra, pp. 847 et seq.

[332] See supra, pp. 856–7, and note 305.

[333] See Table 7, supra, p. 815.

To illustrate, suppose the distributor acquired a long position in the open-end company shares at the price of $9 per share after the close of market because he knew that the effective price for the next day would be $10 per share. The next day anticipated orders did not materialize, and after the close he was apprised that the price would drop to $8 on the following day. He could not always liquidate his position with the investment company without a potential loss, because if he turned his shares in for redemption, even when the price of $10 was still effective, the liquidating value he received was often determined as at the close on the following day, concerning which he could have no advance knowledge. However, on a rising market and with no load to overcome, the risk taken by the distributor would be minimized. Furthermore, if the investment company redeemed on the basis of the current day's market close the risk was eliminated.

The policy of Massachusetts Investors Trust concerning redemptions was stated in its prospectus, as follows: [334]

> The Trustees at present repurchase shares at 10 A. M. at the "net liquidating value" at the previous closing of the Exchange.

It would be possible for a distributor operating under such an arrangement to trade against the underlying fund. For instance, the distributor might purchase a long position at the price of $9 after the close if he knew that the effective price for the next day would be $10. The distributor could then turn in his long position taken at $9 for redemption the next day at the higher price of $10 which he knew would be effective.[335]

The potentialities of these situations were recognized by H. Dudley Swim, vice president of National Investors Corporation: [336]

> Even worse than the possible trading against the lag or "option" is the conceivable situation when a distributor, if not restricted by contract, would have a cross-arbitrage between the bid and asked price on days when the trust's redemption price should exceed the offering price net to the corporation. This potential situation would frequently occur where, as is the custom, the selling price is based on the preceding day's closing asset value and the redemption price is based on the current or the next day's asset value.

The fact that a dealer could make riskless profits from short positions [337] was equally true in the case of the distributor. Any orders received from dealers by the distributor could be delayed in the face of a declining market and covered by the distributor at a lower price through his ability to take down shares from the trust at liquidating value.

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[334] Registration Statement, Massachusetts Investors Trust, File No. 2–3512 (Prospectus, December 15, 1937). This policy was also in effect December 31, 1935. (Op. cit. supra, note 63, at 2413.)

[335] Since December 31, 1935, the policy of the distributor for Massachusetts Investors Trust has been revised and clarified so as to prevent the assumption of a long position through the repurchase of shares from dealers or retiring stockholders except as agent for the trust. (Registration Statement, Massachusetts Investors Trust, File No. 2–3512 [Prospectus August 27, 1938].)

[336] Op. cit. supra, note 102.

[337] See supra, pp. 861 et seq.

The fact that the price lag in the two-price system could benefit the incoming stockholder and the distributor as well as the dealer was also observed by Mr. Swim:[338]

Conceivably, the advantage of this lag may accrue to either the incoming stockholder, the dealer, or the wholesale distributor. Apparently new investors are becoming increasingly aware of the advantage of this one-day lag and place their orders at a time when the lag represents a substantial differential. Many dealers make a particular sales point of this lag to prospective buyers and double their efforts on days when the market has risen sharply, sometimes pointing out that the selling lead is largely or almost wholly offset by the day's increase in asset value. A none too scrupulous dealer whose customer is not aware of the actual operation of this lag could conceivably confirm an order to his customer upon receipt and actually "bucket" the order at absolutely no risk of loss in finally covering, because of the one-day lag which he always has for covering himself against any rise in the market. Similarly, a distributor—unless prevented by contract—could conceivably trade against the fund without any risk of loss in view of the one-day lag, by withholding orders on a day when the market has declined—which withholding might continue over several days in a continuously declining market—or by buying for inventory on a day when the market has risen.

(3) THE SO-CALLED "BOOTLEG" MARKET

The so-called "bootleg market" was the market made by dealers who traded in the shares of open-end investment companies without the authority of the principal distributors for those companies. These dealers would often offer a little more than the published redemption price and ask a little less than the published sale price. In an active market, the unauthorized dealer could still get a greater spread than the authorized dealer.[339] A certain amount of protection was received by such operators through their ability to obtain shares from the legitimate distributors if these dealers were short.[340] Such operations actually had the effect of initiating a small scale price war between retailers and tended generally to disrupt the established offering price.[341] Certain open-end investment companies attempted to overcome this by restricting the negotiability of their shares,[342] providing substantially that the shares could only be sold or tendered for redemption to the open-end investment company.

d. Diminution in Asset Value from the Two-Price System

Although the informed incoming stockholder could benefit from the operation of the two-price system because he could buy in a ris-

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[338] Derived from supplementary information supplied the Commission for National Investors Corporation (memorandum from H. Dudley Swim, June 30, 1938).

[339] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, note 101.

[340] Op. cit. supra, note 128.

[341] Ibid.

[342] For example, Group Securities, Inc. stated as follows in its prospectus (Registration Statement, Group Securities, Inc., File No. 2–1120 [Prospectus, March 28, 1938]):

Certificates of stock of Group Securities, Inc. are fully registered in the name of the owner. They are freely assignable by way of pledge (as, for example, for collateral purposes) but are otherwise nontransferable, in the absence of consent of the corporation, unless the registered holder, or any legal representative of the registered holder, or any purchaser on execution or at any judicial sale, or any pledgee thereof has first offered same to the corporation and it has failed to purchase the shares represented thereby in the manner and on the terms fully described elsewhere in this prospectus.

ing market at the lower of two prices, the existing stockholder nevertheless sustained a diminution of the asset value of his shares. The prospectus of Dividend Shares, Inc., described this situation as follows: [343]

By reason of the method of calculating the offering price, it may not accurately reflect the asset value of the shares at the moment of purchase. Thus, during a day on which security prices are advancing, the Company will, when it sells a share, receive less than the asset value existing at the time of the sale, thereby causing a dilution in the asset value of the outstanding shares. During a day on which security prices are falling, the Company will, when it sells a share, receive more than the asset value at the time of sale. If, therefore, a preponderance of sales should take place on days of advancing prices, the asset value of the outstanding shares would suffer a net dilution, the amount of which is indeterminable.

That a preponderance of sales occurred on days when the market had risen and that dilution on this account could assume substantial proportions was admitted by Mr. Swim: [344]

The present practice of selling shares on a basis of the preceding day's asset value—in fact, in some cases the asset value carries over as the basis of the offering price until ten o'clock on the morning of the second succeeding day—offers a "free ride" to new subscribers at the expense of existing stockholders.

The dilution on this account in a trust which is selling actively could easily amount to several hundred thousand dollars per year.

Experience shows that the bulk of subscriptions are received on days when the market has risen, the subscription prices being based upon the lower asset value of the preceding day. This lag is tantamount to a continuing 1-day option. To the same extent that the incoming subscriber secures a benefit, it is a detriment to the existing investors.

The dilution occurring in the net asset value of outstanding shares arose from the fact that in a period of rising prices new shares were purchased at less than current asset value under the two-price system. Thus, if the offering price amounted to $10 per share on the basis of the previous day's close, and if the market value of the underlying fund rose during the day so that after the close the asset value equaled $12 per share, shares could be purchased on the basis of $10 up to the opening of the markets on the following morning. Thus, every share purchased at $10 was bought below the actual current asset value at the time of purchase. The purchaser paid less for his interest than such interest was actually worth at the time of purchase, and the fund received less than the current asset value of the shares which it sold.

This diminution of asset value which always resulted from riskless trading,[345] arose basically from the lag in the effective price. The lag could only be eliminated through constantly changing the effective price in accordance with the continuously fluctuating asset value or by eliminating the sale of shares at a previous price during the periods when the securities markets were open. Although at least one attempt has been made to surmount the mechanical difficulties

[343] Registration Statement, Dividend Shares, Inc., File No. 2–3588 (Prospectus, July 23, 1938).

[344] Op. cit. supra, note 338.

[345] See supra, pp. 860 et seq.

involved in constantly changing the price,[346] more attempts have been made to limit sales at an old price when a new one was already known.[347]

e. Attempts by Open-End Investment Companies to Eliminate Abuses Under the Two-Price System

Since December 31, 1935, a number of open-end investment companies and investment trusts have revised or clarified their distribution policies so as to make the prospective purchaser aware of the operation of the two-price system, of the possibilities for indirect profits by insiders, and have even attempted to limit trading practices detrimental to stockholders and investors. A few investment companies have attempted to eliminate the two-price system entirely.[348]

(1) LIMITATIONS VOLUNTARILY IMPOSED ON THE TWO-PRICE SYSTEM

Prior to December 31, 1935, the prospectuses of open-end investment companies contained no description of the two-price system and its operation. Ordinarily the investor or the stockholder had no way of knowing that he could have a choice of two prices unless the dealer apprised him of the fact. The investor apparently was not aware that the dealer and distributor could make indirect profits from price calculation adjustments, breakage, matching orders, and riskless trading. He was not told that the two-price system resulted in a diminution of the asset value of outstanding shares.

For example, the prospectus of Dividend Shares, Inc., dated August 14, 1935, did not disclose the existence of the two-price system, but merely stated:[349]

> The Company's shares are offered for sale at a price equivalent to their approximate liquidating value * * * determined as of the close of business on the last business day on which the New York Stock Exchange was open next preceding the date on which a subscription is accepted, plus a premium of 9½% of such liquidating value. In the event of odd fractions, the offering price is adjusted to the nearest cent.

When this statement is compared with the description of the two-price system as given in the prospectus of the same company of July 23, 1938,[350] it becomes obvious that information vital to a prospective purchaser was previously omitted.

Although the earlier prospectus for Dividend Shares, Inc., said nothing concerning trading practices by the distributor, Calvin Bullock, the prospectus of July 23, 1938, stated that it had been the practice of Calvin Bullock to match purchases and sales.[351] This policy was revised so that the distributor was unable to match purchases and sales or assume an inventory position on repurchase of shares, al-

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[346] Institutional Securities, Limited.

[347] See infra.

[348] Impetus was apparently given this movement by the stop-order proceedings instituted by the Commission against T. I. S. Management Corporation. (See supra, pp. 847 et seq.)

[349] Op. cit. supra, note 3, Pt. I (Ex. 9–3).

[350] Registration Statement, Dividend Shares, Inc., File No. 2–3588.

[351] Ibid.

though the selling agreement between the distributor and the investment company has never been so amended.[352] The policy of Calvin Bullock has been further defined as follows:[353]

> However, it is and will be the practice of Calvin Bullock to buy shares from the Company under the distributing agreement referred to below (at the then current offering price, less the aforesaid premium) only in an amount equal to the number of shares called for by Calvin Bullock's customers' orders at the same offering price.

Thus, Calvin Bullock could not assume a long position by taking down shares from the company because it was limited to filling orders on hand, and it could not assume a short position on the basis of current orders, because shares had to be purchased from the company at the same offering price as that at which its orders were received. However, it was stated that because of the bid maintained by Calvin Bullock in the market, the distributor could receive profits or suffer losses from the liquidation of shares with the investment company by reason of the lag in the determination of the repurchase price and also because of unavoidable delays in the delivery of the shares.[354]

Although the possibilities for distributor trading operations have been limited by revisions of Calvin Bullock's policy, no formal attempt has been made by that distributor to eliminate dealer practices detrimental to stockholders and investors.[355]

Recently the contract of Massachusetts Investors Trust, with Massachusetts Distributors, Inc., was amended to permit the taking of a long position by the distributor through the repurchase of shares from dealers or retiring stockholders only as agent for the investment company.[356] Furthermore, the distributor was limited in the taking of a long or short position against the trust.[357]

> It is and will be the general distributor's practice to purchase from the Trust no more shares than are needed to meet purchase orders on hand; and, in filling such orders, not to avail itself (or knowingly to permit dealers to avail themselves) of the opportunity to withhold placing orders from one day to the next to profit the general distributor or dealers by a change in the net asset value from that used in determining the price in their respective purchase orders.

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[352] Ibid.

[353] Ibid.

[354] Ibid. In this connection, it should be emphasized that Calvin Bullock was the sponsor and manager of Dividend Shares, Inc., as well as distributor.

[355] Ibid. "Calvin Bullock has no agreements with dealers requiring them to purchase shares only against their customers' orders, or prohibiting dealers from purchasing shares for inventory purposes or from selling short. Neither the Company nor Calvin Bullock knows the extent to which the latter practices are engaged in by dealers or the amounts of profits, if any, made or to be made by dealers as a result of such practices."

[356] An amendment dated August 18, 1938, to the agreement dated April 27, 1936, between Massachusetts Investors Trust and Massachusetts Distributors, Inc., provides in part as follows (Registration Statement, Massachusetts Investors Trust, File No. 2–3512):

> The general distributor agrees that all repurchases of the Trust shares made by it after this agreement becomes effective, shall be made only as agent for the account of the Trust and pursuant to the terms and conditions herein set forth.

[357] Registration Statement, Massachusetts Investors Trust, File No. 2–3512. The prospectus stated further (ibid.):

> The general distributor and dealers may and do, if so instructed by their customers, withhold orders for the customer's account pendng a price change.

When the distributor was in a position to match purchases and sales it had a twofold effect. First, the distributor could engage in trading operations in addition to and perhaps in conflict with its normal functions. Second, such trading operations on the part of the distributor, whether it was profitable or not, tended to "window-dress" the financial statements of the trust by decreasing the volume of redemptions reported. Inasmuch as statements for the distributor corporation were not submitted to shareholders or contained in the prospectus of the trust, neither the stockholder nor the prospective investor had any information as to this added turnover of shares.[358] Such a situation existed in the case of The Broad Street Investing Company, Inc., where the distributor, Broad Street Sales Corporation, was empowered to trade freely in the shares of the investment company.[359] Although the policy of the distributor was so defined that it precluded the possibilities of taking long or short positions against the investment company, there were no limitations preventing the distributor from assuming a long position in stock repurchased from sources other than the investment company.[360]

The Parker Corporation, principal distributor for Incorporated Investors, on the other hand, could assume no trading positions in the trust shares, because it acted solely as agent for the company in the sale and repurchase of such shares.[361] The investment company, itself, maintained a bid price at which it would repurchase its shares.[362] Any profit or loss from such liquidations accrued to the investment company rather than to the distributor.

In order to avoid trading operations on the part of distributors and dealers, National Investors Corporation placed emphasis on the "bona fide" order: [363]

> All subscription orders placed by the Distributor must represent bona fide orders effective on the day received from the dealer. Under the selling agreement between the Distributor and the dealer, the dealer's order also must represent a bona fide order from his customer. Neither the Distributor nor the dealer is permitted to buy stock for his own account.

H. Dudley Swim, vice president of National Investors Corporation, commented as follows with respect to the foregoing provision: [364]

> This eliminates speculation in the company's stock by those who receive concessions from the offering price as sales compensation. As a matter of general practice it would also be a factor in closing the door against possible "bucketing" of orders.

All of the foregoing measures are by no means automatic and are effective only if enforced. The management of the principal distributor is often identical with the management of the fund while the

[358] Ibid. For the significance of share turnover, see supra, p. 856.

[359] Registration Statement, The Broad Street Investing Company, Inc., File No. 2–1906.

[360] Ibid. Prior to December 31, 1935, it was the practice of the distributor to act as agent. Current practice is not defined in its prospectus. (Reply to the Commission's questionnaire for The Broad Street Investing Company, Inc., Pt. IX.)

[361] Registration Statement, Incorporated Investors, File Nos. 2–3774 and 2–3775.

[362] Ibid.

[363] Op. cit. supra, note 338.

[364] Ibid.

dealer, who enjoys the first opportunity to take advantage of the two-price system, is often too remote to be effectively policed.[365]

(2) ATTEMPTS TO ELIMINATE THE TWO-PRICE SYSTEM

All of the examples discussed in the preceding subsection illustrate ways in which certain open-end investment companies attempted to limit those trading practices of distributors and dealers which flourished under the two-price system. Yet, if both the sales and redemption prices were based on the closing asset value on the day of the receipt of the order many abusive trading practices of distributors and dealers which existed or were possible under the two-price system could be eliminated. In addition, if sales and repurchases were made upon such a basis between sessions of the securities markets, no diminution in asset value could result as the investment company would always receive the current rather than the preceding day's asset value. The objection commonly invoked against this method of pricing and selling shares is that since the price of the shares could not be determined until the close of the market, dealers could not sell such shares during the day without a firm or specific price. H. Dudley Swim, discussing this argument, stated:[366]

> There would of course be some opposition to such a pricing policy from dealers on the ground that they would not have a definite offering price. This does not weigh heavily with me because there would be a definite offering price available from shortly after 3 P. M. until 10 A. M. on the following day, and at the present time most orders are received after the close when the buyer has an opportunity to estimate the day's closing asset value for comparison with the offering price based on the preceding day's asset value. Moreover, investment trust shares are intended only for the long-term investor, who should not be greatly concerned over any given day's price.

Two open-end investment funds, Axe-Houghton Fund A, Inc., and Axe-Houghton Fund B, Inc., both under the same sponsorship and management, did inaugurate such a pricing policy.[367]

Axe-Houghton Fund A, Inc., incorporated August 5, 1938, under the laws of Delaware as a general management investment company with open-end provisions,[368] was sponsored by E. W. Axe & Co., Inc., an investment counsel firm. E. W. Axe & Co., Inc., also had a management contract with the investment company. The fund was designed for those individuals who were desirous of availing themselves of the investment counsel service of that firm but who had less than $100,000 for investment in a diversified portfolio. Shareholders were entitled to redeem their stock at liquidating value, ordinarily determined as of the next close of the New York Stock Exchange following the day on which the stock was received for redemption.

Selling contracts were made between the investment company and two dealers, Counselled Funds Distributors, Inc., and T. P. Burke

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[365] See also supra, p. 826.

[366] Op. cit. supra, note 338.

[367] Axe-Houghton Fund B, Inc., which was identical with "Fund A" except for its investment policy, will not be discussed separately. (Registration Statement, Axe-Houghton Fund B, Inc., File No. 2-3777.)

[368] The following material was derived from the Registration Statement of Axe-Houghton Fund A, Inc., File No. 2-3776.

and Company, Incorporated. Similar contracts were to be made with other dealers upon selection. Under these contracts dealers were to order shares subject to the acceptance of each order by the company upon its receipt. Subsequent to the 30-day initial offering period, orders were to be filled to the dealer "* * * at the next asset value as of the close of business on the day the order is received (or at the close of business on the previous day when the order is received before 10 a. m.), except that, when a dealer orders delivery of any certificate for shares whose basic cost to him was less than $500, an additional charge of 40 cents will be made." [369]

Two factors made this method of distribution essentially different from the customary policies of open-end investment companies. First, this open-end investment company did not plan to employ a principal distributor. Instead, selling contracts were entered into directly with two dealers and the number of dealers under contract was to be increased in the future. Second, the liquidating or asset value at which dealers purchased shares from the investment company was not based on the asset value of the preceding day, but on the asset value determined at the close on the day the order was received.

With respect to the first factor, direct selling contracts with dealers eliminated any chance of distributor trading operations which might be detrimental to stockholders or investors, while the direct relationship probably made dealer supervision easier. However, it must be noted that the elimination of the distributor also did away with the protection against distribution losses which was ordinarily assumed by the distributor. In the purchase of shares from the company, the dealer, subsequent to the initial 30-day selling period, could resell such shares only "* * * at the net asset value taken as of the close of business on the day of resale (except that if the resale is before 10 a. m. it is taken as of the close of business the previous day) *plus* in either case the applicable selling premium stated below * * *." [370]

The selling contracts did not permit dealers to make resales of shares to persons other than bona fide investors without the consent of the investor company nor at any prices other than the established sales premiums.[371] However, officers and directors could buy shares for cash without any premium, and hence were able to take a trading position in a fund they were managing.

The provisions described above plus the fact that dealers did not have a choice of two prices tended to eliminate dealer trading operations in the shares of the investment company.[372] Further, inasmuch as shares were sold only between the closing and opening of the New York Stock Exchange, such shares were sold at actual current asset value, thereby avoiding any diminution in the asset value of shares outstanding.

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[369] Id. (Prospectus, September 1938.)

[370] Ibid. This selling premium was computed upon a sliding scale ranging from 5% on the first $5,000 to ¼% on sales representing a net asset value in excess of $75,000.

[371] At the discretion of the investment company, securities, suitable for investment, would be accepted at current value in payment for shares. In addition, the premium was cut 50% if shareholders of Fund B wished to switch to Fund A, or vice versa.

[372] Although there were no restrictions against the matching of purchases and sales by dealers, there was no extra profit incentive for such an operation because the dealer received the full load in any case.

Corporate Investors, Ltd., incorporated July 30, 1931, under the laws of the Dominion of Canada as an investment company of the general management type, devised a method of postponing the operation of the two-price system.[373] On March 14, 1938, the original authorized capitalization of 1,000,000 common shares without nominal or par value was converted into 999,000 Class A shares and 1,000 Class B shares, both with a par value of $5 each, by Supplementary Letters Patent so as to provide a method of redemption of shares for shareholders.[374] The investment company was sponsored and managed by a group of Ontario financial and business executives. Shares were to be sold by City and Dominion Company, Ltd., the sole agent and general distributor for the investment company, upon an agency and a commission basis.[375] The method of distribution employed by Corporate Investors, Ltd., was through a principal distributor who acted as agent and dealer.

In determining the price of its shares, the investment company attempted to eliminate the inequalities of the two-price system through the use of a stabilization load. This was described as follows:[376]

> The officers of the Company are authorized to adjust the offering price of shares from time to time to an amount equivalent to the liquidating value of shares plus an amount not exceeding 9% of the offering price, provided that no shares will be offered below the par value of $5 per share. The contract with the Company's Sales Agent provides for maximum commission of 7% on sale of the Company's shares and the 9% spread thus provides a margin or leeway over liquidating value plus Agents' commission.

The stabilization load of 2% (the difference between the 9% spread and the 7% selling commission), charged by Corporate Investors, Ltd., was designed to maintain a single effective price over a longer period than would otherwise be possible and to prevent any dilution in the shareholders' equity. Due to the operation of this stabilization load or excess charge, the investment company ordinarily received asset value or more for every share sold. In the usual two-price system where a dealer could trade against the fund, the investment company would ordinarily receive asset value or less. Thus, from the point of view of the stockholders of Corporate Investors, Ltd., the asset value of the outstanding shares could suffer no dilution.

If an investor purchased a share as soon as a new offering price had been determined, he gave the investment company 2% more than the liquidating value of his share. If the liquidating value increased, the next investor gave the investment company the same amount of money, but a larger amount represented the liquidating value and a proportionately smaller amount represented the stabilization load.

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[373] The following information was derived from the Registration Statement for Corporate Investors, Ltd., File No. 2–1646.

[374] Under the Dominion Companies Act, redemption of shares is permissible only in the case of shares of stated par value. Further, the Act requires that there shall be two case of shares of stated par value. Further, the Act requires that there shall be two classes of shares, only one of which will have the redemption privilege. (Ibid., Prospectus, July 20, 1938.)

[375] The loading charge was not to exceed 7% of the offering price.

[376] Op. cit. supra, note 373.

In a rising market this proportion of liquidating value to excess kept changing until the increase in liquidating value had absorbed the entire excess, at which point a new offering price would be established. In other words, the total spread between actual liquidating value and the offering price (exclusive of the selling commission) decreased by the amount that the liquidating value increased, to a maximum of 2%.

It is not clearly revealed in the prospectus as to when the price is changed upon the declining market. If the offering price is maintained during a 2% decline in asset value the investor will bear this 2% decline in addition to the original 2% stabilization load, or a total load of almost 11%.

The effect of this system of pricing was to avoid dilution by charging the investor, in most all cases, a premium over and above the asset value and selling costs.[377] Although Corporate Investors, Ltd., utilized the two-price system to the extent that valuation of shares was based on the portfolio values of the preceding day, there was no overlapping of prices, as the new value became effective immediately upon determination and trading against the fund could be indulged in only to the extent that a change could be anticipated. Furthermore, both the distributor and dealers acted as agents in the sale of shares for the investment company.

Finally, Institutional Securities, Ltd., incorporated under the laws of Delaware on March 18, 1936, as a restricted management investment company with open-end provisions, tried to keep pace with market fluctuations.[378] The authorized capitalization consisted of 50,000,000 shares of the par value of one cent per share. As of September 1, 1938, 5,000,000 shares were classified as Bank Group Shares (also known as "Class I Shares") and 5,000,000 shares were classified as Insurance Group Shares (also known as "Class II Shares"). The assets underlying each Group were required to be invested only in those bank or insurance stocks listed as eligible and were segregated so that each Group represented a separate fund.

The investment company was sponsored by Emlen S. Hare and his associates, was managed by Hare's Research & Management, Ltd., and its securities were distributed through Hare's, Ltd., exclusive wholesale representative and principal distributors.[379]

Shares were to be repurchased by the investment company at "liquidating asset value" determined as of the close of business on the next day after shares were surrendered for redemption less a charge of one cent per share. Any holder of 5,000 Insurance Group or Bank Group Shares (or multiples thereof) could receive upon

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[377] Of course dilution would occur where the market fluctuated more than the excess and the price was not immediately redetermined. The Company stated it would suspend sale of shares under such conditions.

[378] Registration Statement for Institutional Securities, Ltd., File No. 2–2115.

[379] The retail offering price to the public included a commission or load of 8.1% based on liquidating value, equivalent to 7½% of the offering price. Discounts from this commission were originally allowed on single orders of substantial size, from ½% of the aggregate retail offering price on orders from $10,000 to $22,499, to 5% on all orders of $250,000 and over. Further, special discounts were allowed on special retail sales involving the reinvesting of proceeds of sale or redemption of other investment shares.

redemption a proportionate amount of the underlying securities upon payment of the transfer charges, etc., appertaining thereto.

Institutional Securities, Ltd. attempted to overcome the inequalities and trading opportunities presented by the two-price system through a constant adjustment of the offering price. In contrast with the system of Corporate Investors, Ltd. previously described, which attempted to maintain a fairly constant offering price, Institutional Securities, Ltd. described its method as follows:[380]

> In order to protect shareholders against dilution of their assets which may occur when the price of Shares is permitted to remain unchanged after a higher price is indicated by the market prices of the underlying stocks, the Corporation follows the practice of constantly computing throughout the day the market value of its portfolio stocks and a price change is made effective at any time during the day that one is indicated. There is only one offering price for the shares at any time, in that the offering price is promptly changed whenever variations in the prices of the portfolio stocks result in putting the offering price above the next higher even cent or below the lower even cent. Prices are constantly obtained by the Corporation from the trading department of Hare's, Ltd., which obtains its figures through constant contact with dealers and their quoted prices * * *. As there is only one price and that is based on actual "asked prices" of portfolio stocks, neither Hare's, Ltd., or any dealer or investor has any means of profiting at the expense of the Corporation or its stockholders through holding back orders or similar devices. Nor have we found any dilution through current investments being made at higher prices than the figures on which the pricing is based.

Because only one price was effective at any one time and there was no foreknowledge of the next price, trading practices tended to be eliminated. With respect to dilution, theoretically a very small dilution might occur where shares were purchased while the investment company was computing a higher price because of a market rise. However, the fact that the underlying portfolios of this investment company were limited to bank and insurance stocks, tended, in the first place, to reduce any rapid price fluctuations. This had the effect of making it easier for the investment company to follow the market fluctuations of its underlying securities and to keep the price of its own shares in line.

It is not intended to imply that all sponsors or persons connected with the operation or sale of the securities of open-end investment companies took advantage of the mechanical defects of that vehicle to engage in the abusive practices herein enumerated. However, the existence of opportunities to profit in the distribution of the securities of open-end investment companies at the expense of investors is particularly significant in the light of the emphasis upon distribution inherent in such companies, the position of influence or control usually occupied by the principal distributor and the large number of independent dealers upon whose good will and industry such distribution depends.

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[380] Op. cit. supra, note 378 (Prospectus, September 1, 1938).

II. PROBLEMS IN CONNECTION WITH THE DISTRIBUTION OF THE SHARES OF CLOSED-END MANAGEMENT INVESTMENT TRUSTS AND INVESTMENT COMPANIES

A. Methods of Distribution

The period from 1926 to the end of 1929 was the era of principal organization and expansion of closed-end management investment trusts and investment companies—investment trusts and companies which offered no continuing plan for the sale or redemption of their own shares.[1] The 1929 market collapse virtually ended the public offerings of securities of closed-end management investment trusts and investment companies because these shares began to sell in the market at prices below asset values rather than at prices above asset values, at which many investment company issues had previously been selling.[2]

These closed-end investment company securities were distributed in any one or more of the following ways: (1) through public offerings, (2) through private offerings including sales to sponsors, (3) through offerings to own stockholders usually by means of warrants or right to purchase additional securities, (4) through intercompany sales and exchanges including offers of exchange of shares for shares of other investment companies, (5) through the exercise of options, and (6) through gifts, bonuses, and stock dividends.[3]

1. PUBLIC OFFERINGS

By far the most common method of distribution employed by closed-end management investment companies was the public offering—sales to the public generally through the means of underwriting syndicates and retail distributors. This type of distribution accounted for $2,242,000,000, or 55% of the total value of stocks and bonds sold by all closed-end investment trusts and investment companies during the 1927–1935 period.[4] In fact, practically every investment company referred to hereafter in this section at some time had a public distribution of its securities.

The public offering as the primary method of distribution for closed-end management investment trust and investment company securities has already been surveyed in detail with respect to its mechanical operations.[5] The ways in which that method was employed by the sponsors of such enterprises for their own advantage will be considered in this section of the report.

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[1] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, Table 60. This absence of a continuing sale or redemption plan is herein referred to as "closed-end," as contrasted with the so-called "open-end" investment trusts and investment companies previously discussed.

[2] See Ch. I of this part of the report, pp. 17–31.

[3] A statistical survey of the principal methods of distribution employed by closed-end management investment trusts and investment companies is contained in Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 193–201.

[4] If intercompany transactions are excluded from this figure, public offerings accounted for 78% of the resulting total. (See Pt. Two [House Doc. No. 70, 76th Cong.], Ch. III, pp. 196–201, and Table 62.)

[5] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 196–201.

Underwriters were employed in the offering of issues representing 97% of the total gross proceeds of all such public offerings. This general ratio prevailed in every year for the 1927–1935 period and also for every type of security.[6]

The close relationship between investment bankers on the one hand, and investment trusts and investment companies on the other, was a basic factor in the formation and the exploitation of such enterprises.[7] Because of this identity of interests, insiders were in a position to determine among themselves the underwriting arrangements covering the issuance, sale, and repurchase of the invesment securities, and thereby to regulate the costs of distribution to the public as well as the potential profits to themselves. In some instances sponsors apparently organized investment trusts and investment companies as well as series of such trusts and companies because of their salability.[8]

2. PRIVATE OFFERINGS AND SALES TO SPONSORS

Another method of marketing the stock issues of closed-end management investment trusts and investment companies was through private offerings, including sales to "selected" persons. Shares valued at approximately $176,000,000, including intercompany transactions, were distributed by this method during the 1927–1935 period, while $167,000,000 of securities were sold to sponsoring investment bankers, banks, and others (exclusive of investment trusts or investment companies) directly without public offering. These two forms of placing (private offerings and sales to sponsors) accounted for 8% of the total security sales of closed-end investment trusts and investment companies.[9] While some of the securities sold to sponsors were retained by them for purposes of control, undoubtedly a substantial portion was resold to the public.[10]

Almost 25%, or over $40,000,000, of the total shares sold by private offerings was paid for not with cash but with securities which went into the portfolios of the issuing trusts or companies. This compares with 3.5%, or approximately $78,000,000, of the securities of investment trusts and investment companies paid for in this manner through public offerings.[11] When private offerings were made to sponsors or other insiders, particularly when payment was made not

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[6] Id., p. 201, and Table 65.

[7] See infra, pp. 879 et seq.

[8] Ibid.

[9] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 207–9.

[10] Thus, the large controlling interest of Dillon, Read & Co. in United States & Foreign Securities Corporation was somewhat reduced by subsequent sales. (See infra, pp. 943 et seq.)

[11] See Pt. Two (House No. 70, 76th Cong.), Ch. III, pp. 207–9. Blue Ridge Corporation, formed in August 1929, purchased $70,000,000 of the security holdings of its sponsors, Central States Electric Corporation and The Goldman Sachs Trading Corporation, which was made possible largely by the sale of its common stock to a subsidiary of those sponsors. The public offerings by Blue Ridge Corporation included an offer to investors to exchange common shares of any of 21 stated industrial and other corporations for units of the preference and common stock of Blue Ridge Corporation. This offer provided the investment company with only $1,133.00 of additional capital. (Reply to the Commission's questionnaire for Blue Ridge Corporation, Pt. I, and Public Examination, Central States Electric Corporation, at 13609–20 and Commission's Exhibits Nos. 1288 and 1289.)

in cash but in securities, the same parties were, in effect, dealing with themselves because of their control of the investment companies involved.[12]

3. OFFERINGS TO STOCKHOLDERS

In addition to the foregoing methods of public and private offerings, $252,000,000 of securities were sold by closed-end investment companies through offerings to their own stockholders, although the charter provision of most investment companies expressly deprived their stockholders of preemptive rights—the right to subscribe to their proportionate part of additional issues of securities.[13] This amount represents the sale of additional issues by established companies to their own stockholders rather than original offerings to the public generally.[14] The small amount of securities sold in this manner was probably due in some measure to the fact that few closed-end management investment trusts and investment companies had been established long enough prior to the 1929 market crash to attempt any expansion in this manner.

Approximately 63% of the securities sold by closed-end investment companies to their own stockholders during 1928 and 1929 were underwritten by investment bankers, who were usually the sponsors or managers of the investment companies.[15]

4. INTERCOMPANY SALES AND EXCHANGES

The securities of closed-end management investment trusts and investment companies issued in connection with intercompany transactions during the period 1927–1935 amounted to approximately $1,200,000,000, but this figure does not represent the acquisition of new money or capital but a reallocation of existing funds among the companies in the industry.[16]

Cash sales of investment company securities to other investment companies and exchanges of such securities for the securities of affiliated investment companies, most of which occurred during the period prior to 1929, alone accounted for $347,000,000 or 8.5% of total sales by closed-end management investment companies proper and management investment-holding companies.[17] Such financing was especially popular in some of the investment company systems which developed a definite technique whereby reciprocal sales and exchanges were made between affiliated companies at advancing prices. Little or no money actually changed hands until the shares were finally sold to the public at inflated prices.

Investment company securities issued in exchange for shares of other investment companies in connection with mergers and consoli-

[12] See infra, p. 936, for discussion of sales to preferred lists and selected persons.

[13] See Pt. Two, Ch. III, pp. 206–7, and Ch. V of this part of the report, Sec. VI, C, 4. An analysis of the charters of 161 management investment companies filing questionnaire replies with this Commission indicates that 98 of these companies denied preemptive rights to their shareholders without qualification. (Derived from the replies to the Commission's questionnaire for the respective investment companies, Pt. I.)

[14] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 206–7.

[15] Ibid.

[16] Id., pp. 209–11.

[17] Id., Table 62.

dations aggregated $873,000,000 and were accounted for largely by the securities issued by Atlas Corporation and The Equity Corporation and their affiliates in the acquisition of investment companies. These two investment companies and their affiliates issued in connection with such acquisitions $529,000,000 of securities, or 61% of the securities issued by all investment companies in connection with acquisition of control of other investment companies.[18] The amount of securities issued in connection with mergers and consolidations was particularly important after 1929.

5. OFFERINGS THROUGH OPTIONS

During the period of rapid growth and wide distribution of the securities of closed-end management investment trusts and investment companies short-term option warrants—securities evidencing the right to subscribe to or otherwise acquire stock at a specified price during a fixed period of time—were rarely issued. However, these warrants were sometimes used as part of the distribution arrangements.[19] On the other hand, long-term option warrants were frequently employed to "sweeten" security issues and thereby facilitate the distribution of these issues[20] or as special compensation to the sponsoring, distributing, or management groups.[21] These option warrants had active markets and could be sold. Apparently few warrant holders exercised their options and consequently little additional capital was raised by this means. The market decline after 1929 foreclosed the profitable exercise of such options, and their continued existence only hindered adjustments in the capital structures and mergers and consolidations thereafter undertaken.[22] Only $32,500,000 or less than 1% of closed-end investment company securities (exclusive of sales through options forming part of underwriting mechanisms) were sold through this device.[23]

6. GIFTS, BONUSES AND STOCK DIVIDENDS

Sometimes blocks of stock of closed-end management investment trusts and investment companies were issued to sponsors and others not for cash, securities or other property, but in consideration of services performed in the organization, distribution and management of these companies. It would appear, however, that but little stock was distributed in that manner.[24]

On the other hand, stock dividends (the issuance of additional stock to existing security holders as a dividend) and stock split-ups (dividing outstanding shares into a greater number of shares) were common.[25] When properly charged against earned surplus or undi-

[18] Ibid.

[19] See infra, p. 920. (International Superpower Corporation), and Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, Table 66.

[20] See infra, pp. 904 et seq.

[21] See infra, p. 932 (National Investors Group).

[22] Ibid.

[23] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, Table 62, p. 198.

[24] Id., Table 66, p. 248.

[25] The distinctions between stock dividends and stock split-ups were in some instances obscured by the accounting practices of investment trusts and investment companies and the "new capital" thus obtained by the industry was largely theoretical. (See Ch. VI of this part of the report for a discussion of stock dividend practices.)

vided profits, stock dividends were in the nature of compulsory subscriptions by existing shareholders. These methods of distribution cannot be considered as supplying new or additional money to the industry.

B. Opportunities for Underwriting and Investment Banking Business

The fact that a large proportion of the closed-end investment companies was sponsored by persons or firms engaged in the investment banking or security business may be some indication that the formation of these investment companies was motivated by a desire for underwriting business. The statistical analysis of the sponsorship of closed-end management investment trusts and investment companies was complicated by the variety of businesses conducted by the sponsors as well as by the varying degrees of influence or control exercised by them. Therefore, only general classifications of the dominant management groups were made.

As at December 31, 1929, out of a total of 162 closed-end management investment trusts and investment companies, 109 were sponsored principally by houses of issue, bank affiliates, brokers and dealers.[26] In other words, during the period of greatest expansion, approximately two-thirds of these investment companies were dominated by sponsors whose principal business activities involved the distribution of securities.

The investment company represented a medium for a variety of underwriting opportunities. For example, American European Securities Co. was a reorganized Swiss company formed to invest in the rapidly expanding electrical industry in the United States.[27] The American company was created to facilitate the raising of new capital in the United States. Similarly, Bonbright & Co. Inc. sponsored the formation of American Superpower Corporation in March 1923 to absorb the equity issues of utility holding companies which at that time possessed a poor market and for which securities the necessary underwritings were often unavailable.[28] By March 1930 approximately $99,000,000 in cash or property had been received for the issuance of its securities. One of the more common variations in the objective of employing investment companies to stimulate underwriting or investment banking business was the practice of forming these companies to act as co-entrepreneurs with the investment banking sponsors in various investment banking transactions. For example, United States & International Securities Corporation participated in 18 banking, purchase, distributing and underwriting accounts, 16 of which were managed by Dillon, Read & Co., its sponsor.[29]

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[26] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II, pp. 56–9, and Table 25. Mergers and consolidations reduced this group to 122 investment companies as at December 31, 1935, when 61, or exactly half, were so sponsored. With the decline in the security markets there was some reduction in the ratio of investment companies so sponsored. (Ibid.)

[27] This reorganization was effected in 1925. For further details with respect to this company see Pt. One, Ch. III (House Doc. No. 707, 75th Cong.), p. 72.

[28] For further details see id., p. 74.

[29] Hearings before the Senate Committee on Banking and Currency, pursuant to S. Res. 84, 72d Congress and S. Res. 56 and S. Res. 97, 73d Congress, Pt. 4, Committee Exhibit C.

In the underwriting of the securities of an investment company sponsored by investment bankers and security dealers the sponsors could determine its functions, capital structure, distribution contract, management contract, and investment policy. Typically, the charters of investment companies contained few if any restrictions upon their activities and powers; centralized these powers in the sponsors, who made up the officers, directors, executive and other committees; assured to the sponsors continuity of control through a variety of devices; and permitted the dominant persons to enter into contracts with their investment companies involving matters in which they were personally interested. When examined as to the dominance of the sponsor in making the distribution arrangements Hugh Bullock, vice president of Calvin Bullock, testified in connection with its formation of International Superpower Corporation:[30]

Q. Isn't the effect of all that you and Mr. Jaretzki did to completely set the stage for the public offering, in the way that you decided you wanted it?

I mean, that happens in every corporation, I suppose, and it happened here? You set up the corporation and the corporation enters into certain agreements which give a monopoly or a semimonopoly over the sale of its stock for ten years?

A. That is quite customary.

As has been indicated, most closed-end investment companies entered into underwriting agreements for the public distribution of their securities. These agreements fixed the sizes of the offerings, the prices, the spreads or the rates of compensation to the distributors, and the obligations and liability of the underwriter—that is, the underwriter contracted to purchase the securities (made a firm commitment) or merely undertook to act as agent to sell the securities (made a "best effort" contract). Only 59 out of 181 investment companies filing copies of their original "underwriting" agreements with this Commission provided for firm commitments for the shares to be offered and 27, or almost half of this group of 59 companies, were firm only as to a fraction of the total offering. One consequence of the widespread use of so-called "best efforts" underwriting contracts was that the closed-end investment companies and their prospective shareholders had no assurances that the amount of capital which the prospectuses anticipated would ever be raised. For example, Federated Capital Corporation was organized on April 7, 1927, with an authorized capital of $10,000,000.[31] The underwriters made a firm commitment only for $360,000 of the preferred and common stocks at the time of original public offering and for 25,000 additional common shares for $1,250,000 on January 18, 1929 (which the investment company later consented to release as to 8,000 shares).[32] The balance of the $10,000,000 was to be raised through the best efforts of the underwriters. However, ultimately only

[30] Public Examination, Calvin Bullock Group, at 3999.

[31] Reply to the Commission's questionnaire for Federated Capital Corporation, Pt. I.

[32] Ibid. For further details see infra, pp. 940 et seq.

$6,122,680 was raised.[33] William J. Thorold, president of the investment company, testified as follows:[34]

Q. And where there is no underwriting or no requirement that the corporation have a minimum amount of capital before it gets started, he doesn't know what sort of an investment trust he may be in. He may be in an investment trust of $50,000,000 or in an investment trust that has $500,000, isn't that so?

A. Quite true.

* * * * * * *

Q. Although you gave every assurance that you could run a half million dollar trust as well as somebody with a hundred million dollars, of course it is his money that you are seeking to have put into the venture, isn't that so?

A. Yes, sir.

Q. And don't you think that the least that he ought to be able to tell with some degree of certainty, is what the size of the trust is going to be before he puts his money in?

A. It might be of advantage, and I can't differ from you very well, you are so right.

A similar contract was entered into by Samuel Ungerleider & Co. on May 13, 1929, for the distribution of the shares of Ungerleider Financial Corporation.[35] Although this sponsor was firmly committed for the purchase of 100,000 shares for $5,000,000 the underwriting contract as well as the offering circular[36] anticipated the placement of 400,000 additional shares to net the investment company a total paid-in capital of $25,000,000. However, the offering did not prove successful and necessitated extensive trading operations by the investment company. Ultimately only 244,400 shares were outstanding which netted the investment company a total of $13,205,575.76, instead of the expected $25,000,000.[37]

So too, C. D. Parker & Co., Inc., an investment banking firm of Boston, Massachusetts, after having successfully completed the public offerings totaling approximately $23,000,000 for Seaboard Utilities Shares Corporation and Railroad Shares Corporation, offered to the public on November 5, 1929, a third investment company known as Utilities Hydro & Rails Shares Corporation.[38] The authorized capital of this investment company was 15,000,000 shares of one class of stock of which it was anticipated half would be offered to the public at $10.50 a share and the balance would be reserved for delivery under option warrants.[39] The proposed initial capitalization of some $75,000,000 would make this new investment company about three times the size of the previously organized two companies combined. However, because of the unfavorable market conditions during that period only $1,573,508.80 was raised through the sale of the securities and instead of being the largest investment company of the group it was by far the smallest.[40]

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[33] Public Examination, Federated Capital Corporation, Commission's Exhibits Nos. 1472, 1476, 1480.

[34] Id., at 14439–40.

[35] For further details see infra, pp. 937 et seq.

[36] Reply to the Commission's questionnaire for Ungerleider Financial Corporation, Pt. I.

[37] Public Examination, Ungerleider Financial Corporation, at 14909–10.

[38] For further details see Ch. II of this part of the report, pp. 76–94.

[39] Public Examination, C. D. Parker & Co., Inc., at 21037–8.

[40] Id., Commission's Exhibit No. 3244.

Another variant of this type of situation was Chatham Phenix Allied Corporation, later known as Securities Allied Corporation. The entire common stock issues of this investment company, which were offered to net $50,000,000, were underwritten by Chatham Phenix Corporation, the security affiliate of Chatham Phenix National Bank & Trust Company.[41] By October 8, 1929, the date upon which the underwriter was required to take down the securities from the investment company, the sponsor had been unable to market the entire public offering and consequently was without sufficient funds to make full payment. However, the investment company loaned the sponsor the sum of $18,000,000 in order to permit it to complete its commitment. In lieu of commencing business with $50,000,000 in cash, the investment company had only $32,000,000 in cash and an obligation for $18,000,000 by its sponsor. Nevertheless, the management of the company published a circular dated December 4, 1929, reading in part as follows:[42]

> This Corporation was in the advantageous position of having $50,000,000 in cash, all of which was available when the serious decline in the market began, and as of November 30, 1929, the Corporation was in the fortunate position of having $36,615,725 in cash, call, or time loans, which is over 72% of its total assets, and amounted to $18.30 per share of the Common Stock outstanding. The balance of its assets has been invested mainly in listed and readily marketable dividend-paying common stocks of the leading Railroad, Public Utility, and Industrial companies.

This $18,000,000 obligation of the sponsor to the investment company continued in varying amounts and was never less than $7,000,000. Control of the investment company was sold to Atlas Corporation on August 11, 1931, when the balance of $10,566,933 of this debt was paid off.

Illustrative of the rapid successive formation of investment companies by their investment banking sponsors are the companies formed by Field, Glore & Co. of Chicago, and J. & W. Seligman & Co. of New York City.[43] A discussion of them follows.

The Chicago Corporation and Continental Chicago Corporation

The Chicago Corporation was organized on February 9, 1929, as a general management investment company under the sponsorship of Field, Glore & Co., investment bankers.[44] Its original net capital was $59,375,000, raised largely by the sale of units consisting of both common and preferred stocks from which the sponsors received a gross underwriting profit of $2,625,000.[45] The function of the investment company was to serve as a trading concern operating "in the field of finance that lies somewhere in between the commercial banking activities and those of an investment banker."[46] Specifically it

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[41] For detailed discussion of Chatham Phenix Allied Corporation, see Ch. II of this part of the report, pp. 115–146.

[42] Reply to the Commission's questionnaire for Chatham Phenix Allied Corporation, Pt. I (Exhibit 10).

[43] See Ch. I of this part of the report, pp. 2–11.

[44] Reply to the Commission's questionnaire for The Chicago Corporation, Pt. I.

[45] Public Examination, The Chicago Corporation, at 9731. See also Pt. Two, Ch. III, Appendix B, pp. 749–50.

[46] Public Examination, The Chicago Corporation, at 9793.

was contemplated that this would involve participations in reorganizations and long-term investments in companies whose securities could not be offered to the public because of lack of seasoning and which required more permanent financing than could be obtained from commercial banks.[47] However, the investment company did not have much opportunity to engage in this type of business and had invested only a portion of its capital by September 1929.[48]

Nevertheless, on September 11, 1929, a second investment company, known as Continental Chicago Corporation, was formed along the lines of the first, under the joint sponsorship of the Continental Illinois Company and Field, Glore & Co.,[49] who received an aggregate of $2,625,000, gross, for underwriting its shares. The purpose of this new investment company was identical with that of The Chicago Corporation.[50] Furthermore, the new investment company represented an attempt by Continental Illinois Company, the recently organized securities affiliate of the Continental Illinois National Bank & Trust Company, of Chicago, to participate in a stock flotation the success of which was indicated by the recent distribution of the shares of The Chicago Corporation.

Continental Chicago Corporation raised a net capital of $63,750,000 despite the fact that at that time The Chicago Corporation had been unable to find sufficient investment opportunities for its own $59,375,000 of capital funds.[51] The reasons for the formation of Continental Chicago Corporation were summed up by Abner J. Stilwell, vice president of the Continental Illinois National Bank & Trust Company, as follows: [52]

Q. Can you tell us in your own words just what it was they wanted to do with that corporation, in view of the fact that one that was precisely similar was already in existence in Chicago?

A. The Chicago Corporation had been formed, had been accepted by the public as being a successful venture, that statement being qualified by the action of the market in the stock, and the then executive head of the bank felt that this was an expanding field.

Q. That was Mr. Reynolds?

A. Mr. Arthur Reynolds and that the bank in some manner possibly through the creation of a corporation similar to The Chicago Corporation should use its influence in bringing about the creation of such corporation and having a fund of money available for such things as Chicago Corporation and similar corporations were intended to do.

Q. You heard Mr. Glore's testimony yesterday that The Chicago Corporation [old] had been formed as an intermediary financing device to supply financing assistance to those industries that would not be of interest even to a commercial bank on the one hand or an investment banker on the other. Was it also with that in mind that Mr. Reynolds desired the organization of Continental Chicago?

A. In his conversations with me and others, he pointed out that the great clientele of the bank and its diversity would probably afford the corporation, a

[47] Id., at 9673 and Commission's Exhibit No. 9673–4.
[48] Id., at 9729–30.
[49] Id., at 9682.
[50] Id., at 9683.
[51] Id., at 9683–6. See also Pt. Two, Ch. III, Appendix B, pp. 749–50.
[52] Op. cit. supra, note 46, at 9844–6.

corporation such as he wanted organized, even more opportunities than could possibly come to The Chicago Corporation or anyone else in the Chicago field.

The fact that there was little opportunity for the investment of the funds at that time apparently was only of secondary importance to the organizers. Mr. Stilwell testified:[53]

Q. Did anybody ever point out in your hearing that considering the purposes for which The Chicago Corporation was intended at the time it was formed, that so far there proved to be no need for it, and therefore what would be the need for a second one?

A. You mean at that time?

Q. Yes.

A. I don't believe there was any such discussion as that.

Q. Did you ever discuss the formation of Continental Chicago with Mr. Glore, who was also a bank director?

A. No.

Q. It apparently would appear from the testimony yesterday that not only had you there existing financial facilities of the Middle West in The Chicago Corporation for which you had found no need, so that there would be doubly no need for two of them. I wonder if anybody in 1929 pointed out that fact in the discussions which led up to the formation of the Continental Chicago.

A. I don't think there was any such discussion.

By the end of 1929 it was apparent that these two investment companies had collected more funds than the managers could invest and soon after both corporations embarked on a policy of repurchasing preferred stock as a means of reducing their size.[54] As a result, as much money was expended in these repurchases as had been raised by the new company. Charles F. Glore, a member of Field, Glore & Co., and at all times associated with the two investment companies, testified:[55]

Q. Was it pretty much a fact during the year 1929 that you had almost $125,000,000 and were finding it difficult to invest it?

A. That is right, and I think that was realized at the time the money was raised. I am quite sure in The Chicago Corporation we knew that we were not going to be very active. We didn't expect to be as active at that time——

Q. Then, why would you identify yourself with the new one, which doubled the burden of investing,

A. That is a difficult question to answer. The facts are that later we decided that there was no use for that amount of money, and we subsequently, through repurchase of preferred stock, practically diminished the size of both corporations, finally all three,[56] to the point where we are right back to where we started The Chicago Corporation—to approximately where we started, so far as the assets of The Chicago Corporation are concerned.

Q. Was there any element of wanting to get underwriting business while the market was absorbing new securities; whether or not, that had a conscious or unconscious influence on your actions? After all, Field and Glore were underwriters of securities. That was their business.

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[53] Id., at 9848–9.

[54] Id., at 9765–6, 9886–7.

[55] Id., at 9729–30.

[56] The third company referred to is Chicago Investors' Corporation, which was merged with Continental Chicago Corporation to form the new The Chicago Corporation on December 20, 1932. (Op. cit. supra, note 44, Pt. I.)

A. That was their business.

Q. The market was receptive to almost anything during the year 1929, up to the time of the crash?

A. Yes.

As early as September 17, 1929, or almost immediately after the offer of the shares of Continental Chicago Corporation, newspaper articles appeared to the effect that a consolidation of that company and The Chicago Corporation was being considered.[57] Finally, on December 8, 1930 the two investment companies were merged under the name of Continental Chicago Corporation,[58] the name of which was later changed to The Chicago Corporation.

In summary, the organization of Continental Chicago Corporation apparently served no economic need [59] and the repurchases and the merger of The Chicago Corporation with it brought about the same situation as if it had never been created. However, the sponsors, who were the underwriters, received a gross aggregate underwriting commission of $2,625,000 on the sale of Continental Chicago Corporation's shares.

Tri-Continental Corporation and Tri-Continental Allied Company, Inc.

Tri-Continental Corporation, which was incorporated under the laws of Maryland on January 4, 1929 by J. & W. Seligman & Co. as a closed-end management investment company,[60] offered 900,000 shares of common stock to the public and sold 100,000 common shares to the sponsors. The investment company received an aggregate of $25,000,000 for all these common shares. In addition 250,000 shares of 6% cumulative preferred stock, each bearing an option warrant to purchase one share of common stock, were sold to the public for which the investment company received another $25,000,000.[61] J. & W. Seligman & Co., who were investment bankers and members of the New York Stock Exchange and the sole sponsors, received a gross underwriting commission of $3,000,000 and option warrants to purchase 575,000 shares of common stock.[62]

On August 15, 1929 Tri-Continental Allied Company, Inc., which was jointly sponsored by J. & W. Seligman & Co. and Tri-Continental Corporation, was incorporated under the laws of Maryland as a closed-end management investment company.[63] This second

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[57] Id., at 9693. The conflicting interests of two investment companies under interlocking management competing in the same field of investment for business which either company alone would have been able to handle (id., at 9688–91) must soon have been manifest.

[58] Op. cit. supra, note 44, Pt. I.

[59] Op. cit. supra, note 46, at 9690.

[60] Reply to the Commission's questionnaire for Tri-Continental Corporation, Pt. I.

[61] Id., Pt. V; see also Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, Appendix B, pp. 751–2.

[62] Public Examination, Tri-Continental Corporation, at 18518–19. Although these securities were immediately disposed of by the sponsors, that firm operated a stabilizing account in the securities for 5 months following the original distribution. The stated purpose of this account was to secure permanent placement of the stock in the hands of bona fide investors. Although the quoted market price of the stock of Tri-Continental Corporation rose from 27 to 51 during this period, J. & W. Seligman & Co. suffered a loss of $1,167,000 on this operation. (Id., at 18521–5.)

[63] Summary statement filed with the Commission for Tri-Continental Corporation and Tri-Continental Allied Company, Inc.

corporation issued 1,000,000 shares of common stock, 500,000 shares of 6% cumulative preferred stock, each bearing an option warrant to purchase one-half share of common stock, and option warrants to purchase 500,000 additional common shares. Tri-Continental Allied Company, Inc., received an aggregate of $50,000,000 for all these securities. Tri-Continental Corporation purchased 150,000 common shares and option warrants to purchase 500,000 additional common shares for $3,750,000. The remaining shares were sold by J. & W. Seligman & Co., who received a gross underwriting spread of $7,000,000. Tri-Continental Corporation paid an average price of $25 per common share exclusive of option warrants, 50,000 common shares were sold to associates of J. & W. Seligman & Co. at $25 each, while the public purchased units consisting of one share of preferred stock with option warrant, and one and one-half shares of common stock, for $101.50 per unit.[64]

On December 27, 1929 an agreement was negotiated to be effective January 1, 1930, consolidating Tri-Continental Corporation and Tri-Continental Allied Company, Inc. into a new investment company known as Tri-Continental Corporation with combined assets of $75,302,000.[65]

J. & W. Seligman & Co. had received a gross underwriting profit of $3,000,000, plus option warrants to purchase 575,000 common shares on its underwriting of Tri-Continental Corporation,[66] whereas from the distribution of Tri-Continental Allied Company, Inc., the same sponsor received gross underwriting compensation of $7,000,000. Also, Tri-Continental Corporation assisted in the marketing of the shares of Tri-Continental Allied Company, Inc. by taking down 150,000 common shares, and the option warrants for 500,000 additional common shares received by that investment company on that purchase might be considered a special underwriting compensation. Mr. Bailie, when examined on the possible conflict of interest in determining a fair underwriting spread, testified as follows:[67]

Q. Coming back to this difference between these two underwriting spreads, as I understand it, J. & W. Seligman determined in both cases these spreads; is that right?

A. That is correct.

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[64] Ibid. Option warrants attached to the preferred stock of Tri-Continental Corporation were not exercisable until December 31, 1929, while the unattached warrants were not exercisable until a year later. They were all exercisable thereafter until December 31, 1943, at the original issue price of $27 a share. Similarly, the option warrants attached to the preferred shares of Tri-Continental Allied Company, Inc., were exercisable on January 1, 1931, while the unattached warrants were not exercisable until a year later. In this company the exercise price was $33 a share, an advance of $8 over the issue price, and they ran only until August 15, 1939. (Ibid.)

[65] Public Examination, Tri-Continental Corporation, at 18551. To effect this merger the intercompany holdings were canceled, thereby eliminating 150,000 shares of common stock of Tri-Continental Allied Company, Inc., as well as option warrants for 500,000 additional shares. (Id., at 18542.) J. & W. Seligman & Co. surrendered option warrants for the purchase of 123,800 shares of the common stock of the original company and sold 112,000 shares of the preferred stock of the Allied company back to it at $37.50 a share for an aggregate of $4,100,000, in order to equalize the coverage. Exchanges of old stock for new were then effected upon a direct percentage basis. (Ibid.) Apparently, the option warrants represented the greatest potential obstacle to the merger.

[66] Mr. Bailie agreed that a valuation of $2 for each option warrant would be a low figure. (Public Examination, Tri-Continental Corporation, at 18533–5.)

[67] Public Examination, Tri-Continental Corporation, at 18535–6.

Q. And the outside directors did not determine them, is that right; they were brought on after the spread had been determined?

A. There were no outside directors at the time Tri-Continental and Allied were formed. They came on afterwards. The outside directors of old Tri-Continental approved the formation and approved the plan. Therefore, they approved the set-up we suggested, but it was our set-up.

Q. So that is one situation where, in the relation between a banking house and an investment trust, the bankers needed the integrity of a Solomon in order to determine what is a fair price for their underwriting spread. I am not suggesting this was unfair, but I am just endeavoring to point out the possibility. That was a 4-percent spread in the second case?

A. Yes.

With respect to the $7,000,000 gross underwriting profit obtained by J. & W. Seligman & Co., Mr. Bailie testified that because of extensive market operations conducted by J. & W. Seligman & Co. in the investment company's securities after the market crash of 1929,[68] that sponsor sustained a net loss of $851,000,[69] on the entire transaction.

C. Capital Structures Affected by Market Factors

An accompaniment of the practice of creating investment trusts and investment companies to provide underwriting opportunities for their sponsors was the practice of creating capital structures so as to provide issues which would be readily marketable.

One device to stimulate salability was the creation of high leverage structures and securities which had speculative appeal during times of rising market prices. This leverage was obtained either by the creation of capital structures with more than one class of securities—the junior securities possessing the leverage of the senior security backing—or by pyramiding such a leverage company upon another investment company which itself possessed a leverage structure.[70] The operation of both types of such leverage is exemplified by the common stock of Central States Electric Corporation. While a hundred dollars invested in 1923 in the common stock of The North American Company, which was the stock in which substantially all of the assets of Central States Electric Corporation were invested, would have had a market value of about $1,650 by August 30, 1929; a hundred dollars so invested in the common stock of Central States Electric Corporation would have had a market value of $53,991 on August 30, 1929.[71]

National Investors Group

An investment company system, which periodically provided shares representing capital structures designed to appeal to prospective investors under changing market conditions, was developed by Fred Y. Presley when he organized National Investors Corporation, which became the parent of a series of investment companies. National Investors Corporation was organized on June 16, 1927, as "a man-

[68] Id., at 18532. For a further discussion see infra, pp. 967 et seq.

[69] Id., at 18529.

[70] For a discussion of leverage see Ch. I of this part of the report, pp. 12–13.

[71] Public Examination, Central States Electric Corporation, at 12514–7.

aging company to manage the capital of affiliated trusts to be formed" and to invest its own capital "in the junior securities of the affiliates to come." [72]

The plan of organization was developed by Fred Y. Presley, formerly associated with E. E. MacCrone & Company in the organization and operation of The Investment Company of America, another investment company. He severed this association because he "felt that for complete control to be in the hands of the partners of a single house of issue, members of the New York Stock Exchange, would not work out in the long run in the management of that company." [73] In April 1926 Mr. Presley went to New York with the thought of organizing an investment company.[74] At that time he became associated with Eugene L. Richards, formerly superintendent of banks in New York State, and through him it was hoped that commercial banks might be persuaded to sponsor the venture.[75] However, the banks approached by Mr. Richards were unwilling to participate without some substantial support.[76] At the end of 1926 such substantial support was obtained from the Guardian Detroit Company of Detroit, Michigan, as testified by Mr. Presley: [77]

Q. You felt that you were unusually fortunate, perhaps, in hooking up with Guardian Detroit people?

A. Extremely so.

Q. Did they agree with your plan on which you had been working prior to that, that the initial distribution should be largely through banks?

A. Yes.

Q. What was the purpose behind that, Mr. Presley?

A. It seemed to be logical at that time for banks to sponsor an investment trust. It was logical sponsorship, and it seemed logical for banks to become interested in investment trusts, and it also seemed logical with the development of security affiliates. I think that was the era of development, or large-scale development, for these banks to distribute investment trust shares through their affiliates. It also seemed logical from the standpoint of managing an investment trust, for banks to become associated because of their contacts with corporations, and investment situations, and their study of general business conditions.

And further on: [78]

Q. That is to say, your interest in the banks was to facilitate distribution of the trust stock through their advice and such influence as they might have with the customers of their bond departments, and so on; is that so?

A. I thought your question was why would the banks be interested, and I was trying to answer your question from the standpoint of the banks' view.

Q. Yes; and from the banks' point of view you felt that if they were intimately associated with an investment trust they could feel safe perhaps in advising investors?

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[72] Reply to the Commission's questionnaire for National Investors Corporation, Pt. I, and Public Examination, National Investors Corporation, at 4271.

[73] Public Examination, National Investors Corporation, at 4241.

[74] Id., at 4245.

[75] Id., at 4247.

[76] Id., at 4251.

[77] Id., at 4253–4.

[78] Id., at 4254–5.

A. They could feel safer if they were identified either through stock ownership or Board ownership; yes.

Q. And from the point of view of the management of the trusts, the banks would naturally facilitate the distribution of the trust securities.

A. Yes.

An offering of the share of National Investors Corporation was not made until the middle of 1928, by which time the Shawmut Corporation of Boston, Massachusetts, had been brought in to undertake a one-third participation in the underwriting, while the Guardian Detroit Company undertook the other two-thirds.[79] However, only about 25% to 30% of the units so distributed were sold to banks, the balance being retained by those sponsors or sold to their other customers.[80] These sponsors were also the principal distributors of the issues of the other companies in the group.

Representatives of Guardian Detroit Company and Mr. Presley comprised the board of directors of National Investors Corporation, which in turn controlled the other companies in the group until March 1933, when a receiver was appointed for Guardian Detroit Company.[81] This control permitted the Guardian Detroit Company to negotiate the underwriting arrangements substantially upon its own terms.[82] Guardian Detroit Company was willing, however, to let Mr. Presley exercise complete operating control through a series of management agreements.[83]

Marketability and control were the two dominant factors in the creation of the companies comprising the National Investors group. The capital structures of these companies were particularly designed to appeal to changing public tastes. The following tabulation shows the capital structures at the time of original issue:[84]

Name of company	Common shares	Preferred shares	Option warrants	Net capital contribution
National Investors Corp	[a] 40,000	40,000	[a] 160,000	$4,400,000
Second National Investors Corp	300,000	100,000	200,000	10,600,000
Third National Investors Corp	220,000		130,000	10,400,000
Fourth National Investors Corp	500,000		1,000,000	27,000,000

[a] Split six for one, Oct. 10, 1929.

The use of preferred stocks in the first two companies, sold in units with the common stocks, was dictated largely by considerations of marketability,[85] while it also reduced the percentage of investment required to effect control in the sponsors.

[79] Id., at 4264.

[80] Id., at 4268.

[81] Id., at 4260.

[82] Id., at 4259–61.

[83] Id., at 4392.

[84] Replies to the Commission's questionnaire for the respective investment companies, Pt. I and Pt. V.

[85] Op. cit. supra, note 73, at 4297–8. Also, National Investors Corporation was organized under the laws of the State of New York while the subsequent companies were organized under the laws of the State of Delaware, because, as testified by Mr. Presley (id., at 4273–4), New York laws were felt to be more conservative by banks to whom it was intended to sell the shares of the parent company.

The original offering of National Investors Corporation securities was made about a year after organization and consisted of allotment certificates composed of one share of 5½% cumulative preferred stock, one share of common stock, and one 10-year option warrant for an additional one and one-half shares of common at prices ranging from $10 to $20 each. The sale of these 40,000 common shares and 40,000 prefered shares in units, with the added "sweetening" of option warrants for 60,000 additional common shares, was obviously for the purpose of enhancing their marketability. The remaining option warrants for 100,000 shares of common stock, potentially 50% of the voting power, comprised the underwriting compensation.[86] The exercise of option warrants increased the paid-in capital by $952,000 while repurchases decreased this capital by $463,000, leaving a net paid-in capital of $4,889,000 as of December 31, 1935.[87]

Second National Investors Corporation was organized on November 9, 1928, and its securities were offered publicly on November 15, 1928, in units of one $5 convertible preferred share and two common shares for which was received the net sum of $9,600,000.[88] In addition, 100,000 shares or one-third of the common stock was purchased by National Investors Corporation for $1,000,000, with which it received all of the 15-year option warrants for 200,000 shares of common stock at $25 a share.[89] The determining factors in arriving at this capital structure were related in the testimony of Mr. Presley:[90]

Q. What were the factors that determined this capital structure, Mr. Presley? Here again you have preferred stock, but this time it is convertible stock, and you have common. You have preferred in the National Investors, which was not convertible and in both instances you have warrants to purchase common stock. Do you remember what the factors were which determined the form which this capital structure took?

A. Not precisely, but in general, it seemed like a set-up which would be attractive to the investing public, and also a set-up which would be attractive to the junior security holders, a set-up which could be sold to the public.

Q. That is to say, market conditions at the time were what weighed most heavily with you?

A. That certainly would be an important part.

Furthermore, the possession of these option warrants served to insure the parent company and its sponsors against any threat to their control.

Third National Investors Corporation was organized on February 27, 1929, almost immediately after the formation of Second National Investors Corporation. Mr. Presley commented upon this timing as follows:[91]

Q. What were the factors which determined the capitalization of the Third National Investors Corporation, and the timing of its incorporation, as you recall?

[86] Id., at 4263.

[87] Id., at 4257–62; and see the reply to the Commission's questionnaire for National Investors Corporation, Pt. II.

[88] Op. cit. supra, note 73, at 4273, 4277.

[89] Id., at 4277.

[90] Id., at 4276.

[91] Id., at 4295–6.

[92] Id., at 4296–7.

A. The timing was most certainly influenced by the completion of the distribution of Second National securities, and I think that the Third National probably followed as soon thereafter as practicable. I mean from the standpoint of the underwriters.

Q. From the standpoint of whether the market would be receptive to the offering?

A. I think that was unquestionably the determining factor at the time.

Thus, the formation of a new company with a common stock set-up was apparently dictated largely by considerations of distribution.[92] The 220,000 shares of common stock were sold for the net sum of $10,400,000, of which National Investors Corporation contributed $1,000,000. For this investment National Investors Corporation received 20,000 shares of common stock and option warrants to purchase 130,000 additional shares at prices ranging from $60 to $70 each.[93] Warrants to purchase 28,000 shares were redistributed by National Investors Corporation to the selling group to stimulate sales,[94] while the remaining 102,000 warrants sufficed to protect the control of the parent company.

Because of the continued popularity of investment companies with only common stock, Fourth National Investors Corporation was organized 6 months later on August 13, 1929, with 500,000 common shares, each carrying a 10-year option warrant to purchase one-half an additional share at $60 a share, for which the investment company received $24,000,000.[95] In this instance National Investors Corporation participated only by the purchase of option warrants for 750,000 additional shares for which it paid $3,000,000.[96]

Although no satisfactory explanations were given as to why a new corporation was formed when Third National could have been enlarged, it is apparent from the testimony that the basic reason again was one of marketability. Mr. Presley, when examined, testified as follows in this connection:[97]

Q. And what had you in mind, in forming, for example, several affiliated companies of a given size, instead of a single one which in the aggregate would be the same size?

A. One of the considerations was the problem of distribution.

And further on:[98]

Q. Did you consider at the time enlarging Third rather than forming Fourth?

A. No.

Q. For obviously there was no preferred stock in Third. You might have expanded that or you might have formed a new company, and what were the factors that led you to form a new company?

A. The first reason is the same reason for the timing of the Third, that is, the Third National stock had been completely sold by the underwriters, and the second reason, as to the structure, being straight common the same, was that in this very short period of time, between May and August, there was quite a sharp

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[93] Id., at 4299–4301.

[94] Id., at 4302.

[95] Id., at 4307–10 and Commission's Exhibit No. 432.

[96] Id., at 4317–8.

[97] Id., at 4296–7.

[98] Id., at 4305–6.

psychological change by the public toward investment trust shares, in general, and toward common stock set-ups in particular, and it seemed clear that the public, or that a much larger trust could be sold at that time because of the change in the public attitude or the increase in the interest of the public toward investment trust shares.

The change came very rapidly and almost over night.

Q. Wouldn't the public have been equally receptive to an equal offering of shares of Third National?

A. I think that they might have been equally receptive.

Q. Was that discussed?

A. I don't recall whether it was discussed.

Q. Wouldn't that have been more desirable, to have a fewer number of companies, if you obtained the aggregate capitalization that you were seeking, rather than to have a large number of them comparatively small?

A. Looking back, there is no question about it.

Mr. Presley testified that marketability also determined the size of the venture:[99]

Q. What were the factors which made you determine upon this size, and why was it not bigger or smaller?

A. I tried to get the underwriters to float a $50,000,000 issue at this time.

Q. Why, because you felt that the market would absorb it, or because you felt that you could reduce or spread over a wider base your cost of research and management?

A. Both factors, and the first factor being the most important.

D. Selling Practices

While the Commission did not directly explore the sales methods employed by the various distributors and dealers, a number of practices relating to the distribution of closed-end investment company securities have been noted.

1. EXPLOITATION OF GOOD WILL

An investment trust or investment company which could obtain the backing of some established institution at once possessed the elements of respectability and experience which the association implied. These connections were of immeasurable value in marketing the shares of investment trusts and investment companies and often the sponsors sought to exploit these affiliations.

The reputation which commercial banks, investment bankers, and brokers enjoyed in those years during which the closed-end management investment trusts and investment companies received their greatest impetus was probably utilized and exploited as an aid to distribution as much as any other sponsorship. Accordingly, Fred Y. Presley and his associates, when they decided to organize National Investors Corporation, sought and obtained the backing of commercial banks.[100] Mr. Presley admitted that he placed a great premium upon such sponsorship as a means of facilitating the sale of the shares of the ventures.[101]

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[99] Id., at 4311.

[100] See p. 888, supra.

[101] Op. cit. supra, note 73, at 4254–5.

In order to identify the investment enterprise more closely with the sponsor it was not unusual to include the sponsor's name in the name of the investment company.[102] However, this practice of closely identifying the investment trusts and investment companies with their sponsors presented problems when either the investment company or the sponsor got into financial difficulties. This risk to a bank of an affiliation with an unsuccessful investment company was not always fully appreciated at the time of organization of the investment company. Samuel McRoberts, president of Chatham Phenix Allied Corporation, testified:[103]

Q. Was there any consideration given before the name Chatham Phenix was used in the corporate title of the Allied Corporation?

A. I don't recall any.

Q. Well, there was always a possibility that if the Allied Corporation was a flop, it might reflect on the bank, isn't that so?

A. But nobody had any idea it was going to be a flop. It was the intention to link them all together.

And further on:[104]

Q. You had the situation where the name of the bank is tied up with the investment trust, and seeing the market decline in prices of that trust, it necessarily had to reflect on the confidence of the depositors in the bank, even though they were separate and distinct institutions.

A. True. I agree with you absolutely that there should be no connection between a bank operating itself, in the face of all that has happened, I agree with you.

Vick Financial Corporation

Another illustration of this practice of apparent affiliation between sponsors and investment companies was provided by Vick Financial Corporation, an investment company shares of which were sold by Vick Chemical Company, the sponsor, to its customers. While that chemical company did not anticipate underwriting profits from such distribution, it did expect business advantages by reason of the closer relationship thereby created with its customers.

Vick Financial Corporation was organized on May 14, 1929, by the Vick Chemical Company, manufacturers of proprietary medicines.[105] The nucleus of the capital consisted of marketable securities owned by the sponsor and valued at $2,000,000, which were exchanged for 200,000 shares of the capital stock of the new investment company.[106] This stock was then distributed pro rata among the stockholders of Vick Chemical Company.[107] Additional capital was raised by the sale of 391,555 shares to stockholders of the chemical company, who were then identical with the stockholders of the Vick Financial Corporation, under nontransferable rights to purchase 400,000 shares, while 119,000

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[102] A few examples are Prince and Whitely Trading Corporation, The Goldman Sachs Trading Corporation, Spencer Trask Fund, Inc., The Lehman Corporation, and Ungerleider Financial Corporation.

[103] Public Examination, Chatham Phenix Allied Corporation, at 15425.

[104] Id., at 15554.

[105] Public Examination, Vick Financial Corporation, at 3507 and Commission's Exhibit No. 364.

[106] Id., at 3509–10.

[107] Ibid.

shares were subscribed by officers, directors, and employees of Vick Financial Corporation out of 150,000 shares reserved for that purpose. These subscriptions, together with the foregoing exchange, provided a total paid-in capital of $7,105,550.[108]

All unsold shares of the foregoing blocks were reserved for Vick Chemical Company, together with an option to purchase 1,100,000 additional shares at $10 a share until November 15, 1929.[109] These options, expiring November 15, 1929, were the basis of an offering of shares of Vick Financial Corporation by Vick Chemical Company to the drug trade. The reasons for this offering were explained in the following testimony of James Rattray, vice president of Vick Financial Corporation:[110]

A. The reason for it was when the Vick Chemical Company first offered its stock to the public, which was in 1925, a great many druggists wanted to buy the stock. The Vick Chemical Company gave them an opportunity to buy some of that stock and they all made a great deal of money on it. Mr. Richardson expected the Vick Financial Corporation to be successful, and felt it would be doing a good turn to the drug trade, his customers, by making an offering to them of this particular stock.

Q. With respect to these drug or proprietary medicine companies, that was not unusual, was it? Ex-Lax did the same thing, except they gave a bonus of stock.

A. Yes.

The offering was made upon the basis of cash or installments over a 10-month period and was oversubscribed.[111] Accordingly, subscriptions by the drug trade for 858,855 shares were reduced by allotment to 446,243 shares. Employees of Vick Chemical Company were allotted 85,314 shares, and directors of Vick Financial Corporation were allotted 454,190 shares against subscriptions to be filled from this same source.[112]

This offering, made by the sponsor of an investment company bearing a similar name, was obviously for the purpose of enhancing the goodwill enjoyed by that sponsor among the drug trade. If the venture should be a success, it would obviously reflect to the advantage of the sponsor, but if unsuccessful, this close affiliation might become an embarrassing alliance. That the dangers of this possibility were appreciated was admitted in the further testimony of Mr. Rattray:[113]

Q. The fact of the matter is, in a statement that he made to the stockholders at a special meeting of the stockholders on June 13, 1929, he was referring to these opportunities that were to be afforded to the drug trade to acquire stock in the Vick Financial Corporation on a subscription installment plan; was that not so?

A. Yes.

Q. He said, "Your management realizes that the goodwill of the trade will be jeopardized if the Vick Financial Corporation is not successful, but it believes

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108 Id., Commission's Exhibit No. 366

109 Ibid.

110 Id., at 3518–19.

111 Id., at 3521.

112 Id., Commission's Exhibit No. 366.

113 Id., at 3520.

that the benefits which should accrue justify assuming this reasonable business risk"?

A. Yes.

Q. That is, you always had this possibility, that if it is a good thing, of course, it would redound to the goodwill of the Vick Chemical Company?

A. Yes.

Q. But if something went wrong with the Vick Financial Corporation, you were jeopardizing the business of the Vick Chemical Company because of the—shall I say—bad will you created in selling these druggists this Vick Financial Corporation stock? Isn't that so?

A. Yes.

The severe break in the stock market in October 1929 transformed a possible danger of loss of goodwill by the Vick Chemical Company into a probability unless some means could be found to relieve the situation. Inasmuch as the obligations of the drug trade to purchase the stock ran only to Vick Chemical Company, a solution was to release all who wished to get out of their subscription contracts. Such an opportunity was afforded by a letter of October 30, 1929, from Vick Chemical Company to these subscribers, as a result of which subscriptions for 196,783 shares by the drug trade and 44,990 shares by the employees of Vick Chemical Company were canceled.[114] Uncanceled subscriptions increased the paid-in capital to $13,169,950 upon none of which was any commission paid.[115]

By this arrangement Vick Chemical Company was placed in the position of favoring its customers by denying capital to Vick Financial Corporation, which it sponsored.

2. BOARDS OF DIRECTORS

In some instances the policy was adopted of securing persons for the management group who were well known in financial or industrial circles and whose chief contribution was apparently the use of their names.

United States & Foreign Securities Corporation, an investment company sponsored by the investment banking firm of Dillon, Read & Co., and its subsidiary, United States & International Securities Corporation, both possessed of boards of directors which included among their memberships a number of prominent businessmen for the alleged purpose of building up independent organizations to operate these investment companies.[116] The directors of the parent investment company were paid salaries of $5,000 a year while the directors of the subsidiary company were paid salaries of $2,000 a year, which were subsequently reduced to $100 a meeting.[117]

The directors of United States & Foreign Securities Corporation included as chairman Benjamin Joy, formerly a partner of Morgan & Co. in Paris, Robert C. Schaffner, president of A. G. Becker and Co., investment bankers, Grayson M–P. Murphy, head of the invest-

[114] Id., Commission's Exhibit No. 366.

[115] Id., at 3525.

[116] Public Examination, United States & Foreign Securities Corporation, at 11863, and the replies to the Commission's questionnaire for the respective companies, Pt. I.

[117] Public Examination, United States & Foreign Securities Corporation, at 11864, 11869, 11872.

ment bank and brokerage firm bearing his name, and John Sherwin, a prominent paint manufacturer.[118] The average attendance of the members of the board of this investment company was less than 50% during the 1927–1932 period when meetings were held on the average of once a month, Mr. Sherwin attending only 6 out of 64 meetings.[119]

Similarly, the board of directors of the United States & International Securities Corporation included persons of prominence who apparently spent but little time upon the affairs of that company. Among this group was Walter P. Chrysler, prominently identified with the automobile industry, who attended only one of 28 meetings held during the two-year period that he was on the board.[120] Clarence Dillon, also a director and member of Dillon, Read & Co., testified as to Mr. Chrysler's activities as follows:[121]

Q. I am asking what consideration led you to get Mr. Chrysler on the board?

A. On account of Mr. Chrysler's experience and judgment in the manufacturing field.

Q. How often did you call on Mr. Chrysler? How often did you call him on the phone? * * * You don't know how often they did that?

A. No.

Q. Do you realize according to your records Mr. Chrysler attended only one out of 28 meetings during the time he was a member of the board?

A. I think he resigned shortly after that.

Q. He was a director from October 9, 1928, to October 14, 1930?

A. Yes.

The history of this investment company further furnishes instances of this character. For example, J. H. Hillman, Jr., an industrialist of Pittsburgh, was a director of United States & International Securities Corporation from December 13, 1928, to December 13, 1932, during which time he attended but three of the 48 directors' meetings held,[122] and J. W. McConnell, a Canadian capitalist on the board of directors, attended one of 17 meetings held during his incumbency.[123] However, Clarence Dillon testified that these independent directors conferred from time to time with the officials of the companies.[124]

Another illustration was provided by Federated Capital Corporation, incorporated in Delaware on April 7, 1927,[125] under the auspices of William J. Thorold, who had previously been connected with investment companies in England. In 1923, Mr. Thorold sponsored several so-called "fixed investment trusts" in America, and Federated Capital Corporation was intended to offer to American investors the opportunity of investing in a management investment company of the British type.[126]

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[118] Id., at 11866–7.
[119] Id., at 11865, 11872, 11874.
[120] Id., Commission's Exhibit No. 1165.
[121] Id., at 11868.
[122] Id., at 11869–70.
[123] Id., at 11871.
[124] Id., at 11868–73.
[125] Public Examination, Federated Capital Corporation, at 14443, and Commission's Exhibit No. 1471.
[126] Id., at 14428–33.

The members of the Board of Directors of Federated Capital Corporation were selected by Mr. Thorold apparently with a view to their sales appeal.[127] In addition to Mr. Thorold, who became both a director and the president of the corporation, the board included The Rt. Hon. The Earl of Clanwilliam, and Sir Alexander Bannerman, Bart., neither of whom ever attended any of the directors' meetings; Charles H. Guy, a former Justice of the Supreme Court of the State of New York, who resigned as a director on June 27, 1928, and was succeeded by Robert L. Luce, also a former Justice of the Supreme Court of the State of New York; Colonel John H. Price and D. McGregor Mitchell, Directors of the Royal Bank of Canada; and Duncan W. Fraser, vice president of the American Locomotive Company.[128] The presence upon the board of directors of titled Englishmen and of directors of the Royal Bank of Canada presumably aided greatly the distribution of Federated Capital Corporation stock in Canada where approximately one-third of the company's stock was sold.[129] In addition to the usual directors' fee of $20 per meeting, the directors in the United States and Canada, with the exception of Mr. Thorold, were paid $1,000 per annum while those in England received something less.[130] This compensation was paid by the Federal Debenture Company, Inc., and later by the Federated Management Corporation, two companies controlled by Mr. Thorold[131] and which acquired management and exclusive sales agency contracts with the Federated Capital Corporation.[132]

Following the market collapse of 1929, certain of the dealers became dissatisfied with the management of the Federated Capital Corporation and demanded that nominees of the dealers be elected to the board of directors of the Federated Capital Corporation so that they might acquire exact information as to the affairs of the company. Mr. Thorold, however, refused to permit representation of bankers or security dealers upon the board of directors of the company on the ground that they might tend to sell securities of dubious value to the investment company.[133]

Charles Franklin Kettering, a vice president and research director of General Motors Corporation, purchased 40,000 shares of Yosemite Holding Corporation for $260,000 in April and June 1930.[134] This investment was made for Mr. Kettering through his investment organization, as he testified:[135]

> * * * I am not a financier. I am just a mechanic, so I have an organization that takes care of that [financial matters] for me * * *.

However, Mr. Kettering was elected to the board of directors of Yosemite Holding Corporation, apparently without his knowledge or consent, and his name was publicized in the reports of the in-

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127 Id., at 14445–7.
128 Ibid.
129 Id., at 14447–8.
130 Ibid.
131 Id., at 14425–7.
132 Id., Commission's Exhibits Nos. 1472, 1474, 1475.
133 Id., at 14548–51, 14579.
134 Public Examination, The Equity Corporation, at 1455–8.
135 Id., at 1456.

vestment company although he never attended any of its directors' meetings. Mr. Kettering testified:[136]

Q. Let me show you, Mr. Kettering, a report of the Yosemite Holding Corporation to stockholders for the period ending July 1930. * * * That report, Mr. Kettering, is accompanied by a letter signed by Luther D. Thomas, dated August 25, 1930, in which it is said:

"During this period the assets under its control have been largely increased, its headquarters established in New York, and Messrs. Charles F. Kettering, vice president of General Motors Corporation, and James G. Blaine, president of the Marine Midland Trust Company, have been elected members of the board of directors."

Were you conscious of the fact that that was contained in that letter?

A. No, sir; I was not.

Q. Did you ever attend any meetings of the board?

A. No.

Q. Of course, you can appreciate, Mr. Kettering, that that would have some effect on a sales campaign?

A. I do.

Q. And you say you don't know how you got on the board?

A. No.

Q. Did you authorize the inclusion of your name in the sales campaign?

A. In fact, I did not know it was used.

Q. The only thing you knew is you invested $260,000 and got out with $20,000?

A. We have records of that.

Q. Have you had any other experience with investment trusts, either as an investor or member of the board?

A. No; I think that is all. There may have been some minor cases.

Q. Did you have ideas that an investment trust, by and large, is analogous to a life insurance company or some other recognized financial institution? What was your concept of it?

A. My notion of it was that it was a means of buying a participation in a wide range of securities, which the individual investor could not do. That was exactly it. It is akin or about the same participation you would get in, say, one of these single-payment life insurance companies.

Q. You were not conscious of the fact that these investment trusts are not subject to the same supervision as a life insurance company or a bank, or did you know that?

A. No; I did not know that.

The distribution of the shares of Seaboard Utilities Corporation, which was formed on March 20, 1929, and possessed net paid-in assets of $16,525,000 was facilitated by the inclusion of 28 of the dealers and distributors in the board of directors comprised of 45 members.[137] J. Lewis Henry, one of these dealer directors, testified that the election to the board of directors was a form of "flattery" which gave the dealers "a better standing with their present * * * and prospective clientele in the matter."[138]

[136] Id., at 1461–3.

[137] For detailed discussion of this investment company, see Ch. II of this part of the report, pp. 76–94.

[138] Op. cit. supra, note 39, at 21048.

American Capital Group

The American Capital group of investment enterprises pursued the consistent policy of securing men of local or national prominence to comprise the several management groups.

The American Capital group consisted of four investment companies organized between March 27, 1926, and July 17, 1928. The principal sponsor was Jonathan B. Lovelace, at the time a member of the Detroit investment banking firm of E. E. MacCrone & Co. The growth of this group was as follows:[139]

Investment company	Date of organization	Place of operation	Capital at or shortly after organization
The Investment Trust of America (changed to The Investment Company of America, Oct. 23, 1926).	Mar. 27, 1926	Detroit, Mich	$13,182,000
Pacific Investing Corporation [a]	Apr. 15, 1927	Los Angeles, Calif	13,411,000
American Capital Corporation	May 19, 1928	do	15,153,000
Southern Bond & Share Corporation [a]	July 17, 1928	Birmingham, Ala	3,120,000

[a] Merged April 1932, to form Pacific Southern Investors, Inc.

The method of organizing these investment companies followed similar processes in each case. Mr. Lovelace brought together a group of well-known businessmen in each locality to participate prominently in the management and to furnish organization and operation expenses in return for shares or option warrants of the new enterprise. Senior, and sometimes junior, capital was furnished by the public through offerings of securities by various underwriting houses. These offerings were undoubtedly assisted by the publicity given to the identification of such businessmen with the respective investment enterprises, as well as to the persons comprising the staff of Investment Research Corporation, which rendered research services to the American Capital group.

The Investment Company of America

The first of this group was The Investment Trust of America, later known as The Investment Company of America. Distribution of its security offerings was made by E. E. MacCrone & Co.[140]

The advisory board of The Investment Company of America originally consisted of 10 members, at least 8 of whom were prominent in Detroit banking and industrial circles.[141] Among them were Standish Backus, president of Burroughs Adding Machine Company; Roy D. Chapin, chairman of the board of directors of Hudson Motor Car Company; Charles S. Mott, vice president of General Motors Corporation; James S. Holden, chairman of the board of directors of Security Trust Company; and E. D. Stair, president of the Detroit Free Press. The advisory board had no power either to make invest-

[139] Replies to the Commission's questionnaire for the respective companies, Pts. I, II, and V.

[140] Public Examination, American Capital Group, at 7011.

[141] Id., at 7034–5.

ments, to fix general policy, or to participate in active management, but could only exercise a veto power by the creation of an "eligible list" of approved securities.[142] Mr. MacCrone, of the firm of E. E. MacCrone & Co., who selected the members of this board, testified as follows with respect to his conception of their duties:[143]

A. In Mr. Lovelace's testimony, he indicated as being his opinion that the Advisory Board was formed to represent the shareholders.

I was principally responsible for the formation of the Advisory Board, and, as a matter of fact, I might say wholly so, and under no circumstances did I expect or anticipate that they would protect the shareholders. They were asked to join for—more particularly to check our opinions as trustees, and with the hope that their long business judgment would equip them to do that.

Q. You didn't regard them as being in the place of a Board of Directors of a corporation?

A. Absolutely not at all, and I remember very definitely the feeling that they might check the trustees, but never that they would stand between the trustees and the shareholders.

I have always held, and all of my experience proves, that you should have direct responsibility from the beneficiaries to the managers and any action which they took later on, I think, was ill-advised and, I think, harmful.

When this advisory board sought to assume a greater degree of authority over the affairs of the investment company during the period of the market decline, their suggestions appear to have been disregarded. Mr. MacCrone testified in this regard:[144]

A. The specific remedy I would make would be a more direct responsibility probably between shareholders and the management. I would most certainly eliminate the advisory board. The advisory board not only did not prove to be helpful but it proved at every point to be detrimental. In the good old days it O. K.'d very largely what things we did but naturally objected in the unhappy days.

But again, in order to understand that, you must have the background of the situation. Detroit was rushing toward a banking crisis. All of these men sat on the boards of these banks and were dominated by the theories of the general situation.

There was also established an economic council with even less authority than the advisory board. The council possessed no right of veto and could do nothing except to supply information upon request. The members of this economic council, selected by Mr. Lovelace, were Joseph S. Davis, Professor of Economics at Stanford University and Director of the Food Research Institute; Edmund E. Day, Professor of Economics and Dean of the School of Business Administration of the University of Michigan; Irving Fisher, Professor of Economics of Yale University and chairman of the board of Kardex Institute; and David Friday, economist and Director of the National Bureau of Economic Research.[145] These men, whose names had considerable appeal at the time the shares of The Investment Company of America

[142] Id., at 7037–8.
[143] Id., at 7227.
[144] Id., at 7237–8.
[145] Id., at 7028–9.

were marketed, were engaged to perform duties as described by Mr. MacCrone:[146]

Q. Were they consulted on the capital structure?

A. No, sir.

Q. Did they have anything at all to say about the manner of its financing?

A. No, sir.

Q. Then their thought that it was soundly conceived was based on what, the plans that you had for the investment?

A. The idea was sound, of an investment trust, and I don't wish to again contribute anything as to other elements, and I assume that the very fact that they permitted themselves to become associated with it was evidence that they felt that the basic idea was sound.

Q. Did they ever meet in Detroit as a body?

A. No, sir; it was not assumed that they would.

Q. What did you conceive their duties to be?

A. They would consult on particular matters in connection with our programs, and it was assumed that the trustees would, through the research, prepare suggestions, based on their idea of economic trend and so forth, and that these would be submitted to those gentlemen, and they would express opinions about it from time to time, and particularly with reference to their individual fields, and Dr. Day, with reference to industries, and Dr. Davis with reference to agriculture.

Q. This was all done by correspondence, I gather.

A. I think that I never saw these men personally.

While members of the economic council may have aided to a limited extent in advising the company, yet they clearly had no active part in its management or choice of portfolio securities. It is difficult to appraise the actual contribution of the economic council. David Friday, one of the members of the economic council, was not at all clear as to whether the management could have functioned just as well or better without it.[147]

Mr. Friday indicated that his conception of his position was that he was to be one of four individuals who might be called upon from time to time for advice upon specific and special fields. He met with the Advisory Board perhaps 10 or 12 times, but he made no thorough study of the capital structure of the company.[148] In these activities he was probably the most active member of the economic council.[149] The advertising value of this group published in the circulars of the investment company was admitted by Mr. Friday in his testimony:[150]

Q. Did it ever occur to you, Dr. Friday, that one very tangible contribution you could have made to the trust was to have your name on the sales circular, with a view to promoting sales in the State of Michigan, where, as you say, you made quite some name for yourself, and your success of predicting the 1920 and 1926 situations?

A. I had left Michigan in 1923, and I am always——

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146 Id., at 7030–1.

147 Id., at 7200.

148 Id., at 7190–2.

149 Ibid.

150 Id., at 7192–3.

Q. You were known outside of Michigan, I don't want to limit that, but did it ever occur to you that that would be a very tangible contribution that you would make to this trust?

A. Well, I suppose they thought so, but I always discounted that sort of thing a good deal.

Q. Don't you think that the presence of names such as these on circulars facilitates sales?

A. I imagine that they did at that time; yes, sir.

Moreover, it appears that the members of the council permitted their names to be used in advertisements,[151] not because of any conviction as to the basic soundness of the company's organization but merely because of their confidence in the men who were creating it, and, incidentally, from whom they received compensation.[152] This confidence was at least sufficient for Mr. Friday, who testified further: [153]

Q. In permitting your name to go on the circular, you didn't feel that it was your job to go into the matter of the securities that were being promoted by that circular, if you felt that you had confidence in the men who were creating these securities? Is that it?

A. That is it, practically; yes.

The actual responsibility for operating the investment trust was lodged with five trustees, one of whom was Director of Research and thus included in the list described above. The other four represented the sponsors and their attorneys and their names received but little prominence.[154] While the actual managers of the trust were not advertised, the names of the members of the advisory board, the economic council, and the research department received the sort of display which was aimed to convince the investors of the array of talent which would be at their disposal.

Pacific Investing Corporation and American Capital Corporation

The next investment companies in this group were Pacific Investing Corporation and American Capital Corporation, organized by a group in Los Angeles, California. Henry S. McKee, president of Barker Bros., Incorporated, and a director of Merchants National Trust & Savings Bank, headed this group and became the president of the two investment companies.[155] The securities of these com-

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[151] The use of the names of the members of the advisory board and of the economic council as an aid to distribution is clearly illustrated in the circular dated April 19, 1927, offering $2,500,000 of preferred stock of The Investment Company of America. In this circular the names of the members of the advisory board and the economic council are set forth with considerable prominence with a three- or four-line note indicating the affiliations of each person. In addition, the names of five members of the research department of Investment Research Corporation were set forth in similar detail and had equally as impressive antecedents. (Op. cit. supra, note 140, Commission's Exhibit No. 669.)

[152] According to the testimony of Mr. Lovelace, there was an honorarium paid to the members of the economic council which ranged from $150 to $400 a month, with Professor Irving Fisher as probably the most highly paid member. (Op. cit. supra, note 140, at 7076.)

[153] Op. cit. supra, note 140, at 7195.

[154] Id., at 7076.

[155] Id., at 7080–1, and Commission's Exhibits Nos. 674 and 677.

panies were marketed by Blyth, Witter & Co. and Bonbright & Co., respectively.[156]

Among the directors of the two companies were E. J. Nolan, president of Merchants National Trust & Savings Bank, John Treanor, president of Riverside Portland Cement Company and R. H. Ballard, president of Southern California Edison Company.[157] By this time the economic council had become a department of Investment Research Corporation. Accordingly, the prospectuses for the issues of Pacific Investing Corporation referred to the members of its board of directors and of the research department of Investment Research Corporation by names and affiliations, and to the members of the economic council as "composed of a group of distinguished economists of scientific recognition."[158] The prospectus of the American Capital Corporation also included the names and affiliations of the economic council.[159]

Southern Bond & Share Corporation

The last investment company of the group to be organized was Southern Bond & Share Corporation. This investment company conducted its business from Birmingham, Alabama, the home state of Mr. Lovelace, and the directors were drawn largely from the southern area.[160] Robert Jemison, Jr., president of The Jemison Companies, Inc., and director of The First National Bank of Birmingham, was elected president of Southern Bond & Share Corporation. The Board of directors included George G. Crawford, president of Tennessee Coal, Iron and Railroad Company, William S. Farish, president of Humble Oil & Refining Co., and Mathew Sloan, president of the New York Edison Company. Neither Mr. Farish nor Mr. Sloan attended any board meetings and made practically no contribution to the operations of the investment company.[161]

Mr. MacCrone testified that the theory of securing these and other leading men for the board of Southern Bond & Share was that through the boards of directors of this company and other affiliated investment companies the group would have prominent men in all regions of the United States who could be useful in aiding their investment and management policies.[162] However, actually, the only apparent usefulness of most of these men was limited to the sales appeal of their names on the original prospectuses and offering circulars. Their actual contributions to the policies of these companies were apparently insignificant.

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[156] Ibid.

[157] Ibid.

[158] Id., Commission's Exhibits Nos. 674 and 675.

[159] Id., Commission's Exhibit No. 678. An underwriting agreement dated May 19, 1928, between American Capital Corporation and Bonbright & Company, Inc. (id., Commission's Exhibit No. 679) provided that the underwriter should not use the names of members of the Economic Council in published advertisements of issues underwritten by the banking house.

[160] Op. cit. supra, note 140, at 7040–1.

[161] Id., at 7054–5. In fact the only advice given by Mr. Sloan to the company was the recommendation of the purchase of Guaranty Trust Company stock at $1,200 a share, an investment which proved to be quite unprofitable for the investment company. (Id., at 7055.)

[162] Op. cit. supra, note 140, at 7058–9.

Again, the prospectus offering the stock of this investment company through E. E. MacCrone & Company made full use of the names and affiliations of these directors, as well as the personnel of The Investment Research Corporation, including the economic council.[163]

After the securities of all of these investment companies had been distributed and market conditions held no promise for further successful issues, the economic council was dissolved. Mr. Friday's testimony is illuminating in this regard:[164]

> Q. * * * When did you reign as a member of the economic council?
>
> A. I didn't resign. They dissolved the thing in 1930 and that was the end of it, and I think that I must have been there 10 or 12 times.
>
> Q. You mean without consulting you, they just dissolved it?
>
> A. That is my recollection, and I think it was in 1930.

3. "SWEETENING" OF SECURITY ISSUES

A selling practice employed in the period preceding the market crash in 1929, when junior or equity securities enjoyed the particular favor of investors, consisted of offering the senior securities of an investment company in combination with some equity participation so as to attract investors. This device was especially useful in securing the marketing of senior securities which did not enjoy particular appeal in themselves. The marketing of such senior securities was necessary to provide the leverage structures designed by sponsors who usually retained most of the junior securities for themselves. The various methods by which this distribution of senior securities in combination with junior securities was accomplished were known as "sweetening" the security issue.

a. Conversion Privileges, Free Stock, and Option Warrants

One method of "sweetening" was to provide junior participation to senior securities of investment companies by according the security holder the privilege of converting the senior security into the issuing company's common stock. Manifestly, this type of "sweetening" would possess particular appeal if the underlying common stock had previously enjoyed a favorable market.

Central States Electric Corporation, whose common stock experienced phenomenal rises in market value during 1928 and 1929 (due largely to the operations of Harrison Williams interests in that stock and the stock of portfolio companies), utilized this sales technique in marketing two issues of preferred stock in 1928 and 1929. By September 1928, the common stock of Central States Electric Corporation had risen to a price of 112 from a low of 30 in the early part of the year. On September 5, 1928 the investment company offered $10,000,000 in 6% preferred stock, to which it attached the privilege of converting it into the company's common stock,[165] on the basis of one share of common stock for each $118 in par value of preferred

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[163] Id., Commission's Exhibit No. 672.

[164] Id., at 7191.

[165] Op. cit. supra, note 71, at 12704, and Commission's Exhibit No. 1228. Common stock dividends of 100% in April 1929 and of 200% in July 1929 (*Poor's Government and Municipal Section*, 1930, p. 1088) subsequently altered this basis of exchange.

stock. It was admitted that this conversion privilege was utilized as a selling feature in marketing the issue. James Forrestal, vice president of Dillon, Read & Co., which had financed many of Central States Electric Corporation's issues, testified:[166]

Q. This preferred stock, $10,000,000 worth, or 100,000 shares, has two dress-up figures; one is that it is convertible into common at $118.

A. Right.

* * * * * * *

Q. Coming to the first figure, it is emphasized in the circular, that it is convertible. It also states in the circular, that the present market value on the New York Curb of Central States is $112 per share, doesn't it? * * *.

A. Yes.

Q. So that at the time one of the selling features of this stock is the fact that it is convertible at $118 per share * * *.

A. And selling at $112; that is right.

Q. Convertible at $118 and it is selling at $112. So that is right in the range, isn't it?

A. Yes.

Q. There is a possibility of its being convertible right away?

A. It is an attractive conversion, I would say.

Q. And it would have an effect on the sales, wouldn't it?

A. I think so.

Q. It would help sell it, make it more attractive.

A. I think so.

During 1929, with continued vigorous trading activities on the part of Harrison Williams, the common stock of Central States Electric Corporation experienced even greater price rises. In order to keep the market price of the preferred stock in line with the market price of the common stock and thereby prevent conversions and short selling, the investment company engaged in a program of repurchasing this issue of preferred.[167]

Despite this repurchase activity, engaged in after February 1929, Central States Electric Corporation made an additional offering of $10,000,000 of convertible preferred stock in June 1929 at $100 a share.[168] However, this new preferred stock, which was also convertible into common stock on the basis of one share of common stock for each $118 of par value of preferred stock, was issued shortly after the investment company had declared a 100% stock dividend[169] so that the new conversion privilege was but half as attractive as the old.[170] This offering of the 1929 issue of convertible preferred stock, which met with particular success, also coincided with sharp rises in the market price of the common stock which, at the time of the offering, was quoted on the New York Curb Exchange at approximately $110 a share.[171]

Another means of making senior issues of investment companies more attractive was by attaching shares of full-paid common stock or

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[166] Op. cit. supra, note 71, at 12706–7.

[167] See infra, pp. 961 et seq.

[168] Op. cit. supra, note 71, at 13139–40, 12869–70, and Commission's Exhibits Nos. 1234, 1235, and 1236.

[169] See note 165, supra.

[170] Op. cit. supra, note 71, at 12885.

[171] Id., at 12887–91, and Commission's Exhibits Nos. 1234, 1235, 1236. This market price of the common stock was displayed in the offering circular of June 11, 1929.

option warrants for the purchase of common stock at specified prices. Such warrants were of perpetual or limited duration, were often exercisable at graduated prices, and sometimes were not exercisable for a period of time after issuance.

Both free stocks and option warrants were employed to facilitate the distribution of a $20,250,000-debenture issue by Italian Superpower Corporation.[172] This investment company was organized by Italian and American sponsors to invest primarily in the shares of Italian utility companies and control was vested in the two groups of sponsors by equal division between them of full-paid, Class B, common stock which possessed the entire voting power. Pursuant to the original plan of this financing, the American sponsors, consisting of Bonbright & Co., Inc., and Field, Glore & Co., Inc., also received a block of the investment company's Class A, nonvoting, full-paid common stock of which it was planned 303,750 shares would be distributed in connection with the sale of debentures. However, at the time of the public offering these sponsors were able so to gauge the market that they found it necessary to give with the debentures only one-third of these common shares together with option warrants for the purchase of the balance of such common shares.

The market factors allowing the withholding of 202,500 Class A, nonvoting, common shares from the investing public for the benefit of the American sponsors were discussed in the testimony of Sidney A. Mitchell, a director and subsequent president of Italian Superpower Corporation and president of Bonbright & Co., Inc.:[173]

A. After the deal was originally agreed upon with the Italians, stock markets in Italy went up. The value of the assets acquired by the new corporation was considerably in excess of the amount the new corporation was to pay for those assets. Conditions in the investment market in New York also improved during this same period. When the time came to sell those debentures, at the last minute, it was our judgment that instead of giving the entire A stock, which the American investment bankers would receive, to the public, we could give them some of the A stock and option warrants for the balance.

If we had done it two weeks earlier they would have received all of the A stock; if we had done it two weeks later they would have received all of the A stock. As it happened, market conditions on that particular date were such that it was not necessary in order to sell those debentures at that price, to do it.

Q. So that the amount of the participation in the equity that the American public got was dependent on what you thought you could sell?

A. Of course. So was the price they sell power also dependent on market conditions.

The option warrants were not issued by the investment company but were issued by Bankers Trust Company as depository for the American sponsors. Consequently this withholding of Class A common shares inured exclusively to the benefit of these sponsors who stood to receive the proceeds of the purchases of shares under these warrants and the shares deposited against all unexercised options.

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[172] See infra, pp. 930 et seq.

[173] Public Examination, Italian Superpower Corporation, at 7662–3.

Shawmut Bank Investment Trust

Shawmut Bank Investment Trust gave warrants convertible into common stock without further payment, with its debenture issues so that the apparent "sweetening" was in lieu of a common stock equity cushion.

Shawmut Bank Investment Trust was organized February 23, 1927, by the National Shawmut Bank and its security affiliate, Shawmut Corporation.[174] The trustees of the investment trust were officers and directors of the bank, while the bank and its security affiliate had identical stockholders.[175]

One of the purposes in forming this investment trust, as testified by Frederick A. Carroll, vice president and trust officer of the bank, was to create a credit medium for its customers.[176] Accordingly, the good will of the bank, which contributed its name to the investment trust, was used by Shawmut Corporation in marketing the trust shares.[177] Furthermore, it was recognized that such a venture would provide underwriting business for the security affiliate of the bank.[178] The underwriting commission of $50,000, computed at 1% of the public offering price, while low, was admittedly in payment for a simple operation.[179]

The character of the public offering of the investment trust was apparently influenced by considerations of marketability. The capital structure consisted of two so-called "senior debenture" issues due in 1942 and 1952, respectively.[180] One issue consisted of $2,500,000 of 4½% debentures, issued in $1,000 units with warrants convertible into 10 common shares without further cost.[181] The other issue consisted of a like amount of 5% debentures, each $1,000 unit carrying a warrant convertible into five common shares without further cost.[182] An issue of $1,000,000 worth of 6% "junior debentures," maturing in 1952, was sold to the National Shawmut Bank together with warrants for the remaining half of the common stock for $1,040,000.[183] Accordingly, on the date that the investment trust commenced business it had assets of $5,990,000 against liabilities of $6,000,000.[184] Since this investment company was in form a common-law or business trust controlled by trustees, this allocation of the common stocks contributed nothing to the complete control of the investment company already insured to the sponsor bank.

The debentures had none of the characteristics of an ordinary bond issue except for the maturity dates, as they were not collateralized and did not contain a touch-off clause, and the investors' position was more nearly equivalent to that of the holder of an unsecured promis-

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[174] Public Examination, Shawmut Bank Investment Trust, at 3288–9.
[175] Id., at 3289, 3306–7.
[176] Id., at 3288–9.
[177] Id., at 3312.
[178] Id., at 3289.
[179] Id., at 3312.
[180] Id., at 3292–5.
[181] Ibid.
[182] Ibid.
[183] Ibid.
[184] Id., at 3295–6.

sory note or a general creditor of the investment trust. Mr. Carroll testified in this regard:[185]

Q. I would like to examine into the nature of these debentures. They were not issued under a separate indenture, were they?

A. No.

Q. They had no participating rights?

A. No.

* * * * * * *

Q. These debentures had no sinking fund?

A. Right.

Q. No provision for gradual retirement of debt as the date of maturity approached?

A. Right.

The indenture contained no provision accelerating the maturity of the debentures in the event of default in the payment of interest or by reason of any deficiency of assets in ratio to the amount of funded debt outstanding. Other notes and debentures could be issued and outstanding, even senior to these debentures, to 120% of the total indebtedness.[186] Accordingly, it would seem that the very term, "senior debenture," was employed chiefly to facilitate the sale of the issues. The junior debenture issue, purchased by the National Shawmut Bank, was apparently styled to meet the requirements of the terms of an amendment to the National Banking Act which became effective on February 25, 1927, two days after the creation of the investment trust.[187]

In order to induce the public to purchase the senior debentures it was necessary to add speculative features. This was done by giving debenture holders a share in the equity by attaching warrants for full-paid common stock. These warrants were nondetachable except upon presentation of the debentures to the depository or registrar after a date to be designated by the trustee, which should in any event be prior to the record date of the original dividend.[188] At that time holders of debentures would be entitled to receive without cost the shares of common stock covered by their warrants. These provisions served to prevent the immediate split-up of units and the sale of debentures at a discount while the trust was still distributing its securities.

This role played by the warrants is apparent from a comparison between the market price of the units and the market price of the debentures after the warrants became exercisable in March 1928, a year after the original offering.[189] During 1927 the units averaged around $1,240 for the 4½% debentures and $1,100 for the 5% debentures. The debentures ex-warrants in 1928 sold at $860 for the 4½'s

[185] Id., at 3299–3300.

[186] Id., Commission's Exhibit No. 354.

[187] Act of February 25, 1927, c. 191, sec. 2; 44 Stat. L., 1926:

Provided, That the business of buying and selling investment securities shall hereafter be limited to buying and selling without recourse marketable obligations evidencing indebtedness of any person, copartnership, association, or corporation, in the form of bonds, notes, and/or debentures, commonly known as investment securities, under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency, * * *.

[188] Op. cit. supra, note 174, Commission's Exhibit No. 354.

[189] Id., at 3293.

and 900 for the 5's. The common stock was then selling at $37 a share.

b. Unit Offerings

The most usual method of "sweetening" consisted of offering the securities of an investment trust or investment company in the form of units—either in the form of a package consisting of various classes of the capital stock and bonds or in the form of an allotment certificate which was exchangeable at a later date for the actual securities. These units frequently embraced convertible securities and option warrants as previously discussed.[190]

The importance of this method of financing is indicated by the fact that during the years 1927–1935, out of $3,239,000,000 of securities marketed by investment companies proper (including companies in the Atlas Corporation and The Equity Corporation groups), it is estimated that some $940,000,000, or over 29%, were sold in the form of units of common and preferred stocks.[191]

By combining senior and junior securities in one package, the sponsor-underwriters advertised that by paying for the senior security and its theoretically stable income, the investor would also receive, either free or for a nominal charge, a share in the equity as well. Thus the sales appeal was that the investor could buy senior securities to insure safety of principal and income and acquire the equity securities as a speculation gratis or for a nominal amount. However, the effect was to market senior securities which at the time were relatively unmarketable alone.

Such an instance was provided by General American Investors Company, Inc., which was organized on January 25, 1927, under the joint sponsorship of Lehman Brothers and Lazard Frères.[192] The capitalization of this investment company at organization consisted of $7,500,000 principal amount of debentures, $1,500,000 in preferred stock, and 200,000 shares of common stock.

The debentures were sold to the public in units with warrants for common stock, each $1,000 debenture carrying a warrant for 10 fully paid common shares which could not be detached prior to the record date for the initial dividend upon the common stock without the consent of the board of directors.[193] Raymond D. McGrath, a partner of Lazard Frères and secretary of General American Investors Company, Inc., stated the reason for offering these debentures in units with warrants for common shares as follows:[194]

A. The curious thing about the situation that existed at that time was that it was quite the reverse of the present time. The senior securities per se, without any trimmings, of investment trust securities did not have sufficient attraction or were selling at a discount, you see.

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[190] For a discussion and definition of units see Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 193–6, and note 22.

[191] This percentage would be increased to some extent by the addition of units of bonds and common stock, which were not segregated for the purposes of these statistics. (Pt. Two [House Doc. No. 70, 76th Cong.], Ch. III, Table 61.)

[192] For further details see infra, pp. 950 et seq.

[193] Public Examination, General American Investors Company, Inc., at 5717 and 5727. The sponsors agreed to purchase the entire issue of preferred stock and 125,000 shares of the company's common stock, for which they paid $1,800,000. (Id., at 5717.)

[194] Public Examination, General American Investors Company, Inc., at 5726.

Q. Might that not have been one reason why you attached warrants to the bonds, or you wouldn't have been able to sell the bond?

A. There is no question about it, in that market condition. We were not responsible for it, but we had to recognize it.

The Investment Company of America

Another illustration of marketing senior securities in units with junior securities in order to make the senior securities more attractve to the buying public is presented in the case of The Investment Company of America, which was organized on March 27, 1926, as The Investment Trust of America, a business trust having its principal place of business in the State of Michigan. The name of the trust was changed to The Investment Company of America on October 23, 1926, when some superficial organic changes were made to constitute it a Michigan trustee corporation (in effect a trust), and not until April 1927, a year after original organization, was a public offering made of its shares.[195] The principal sponsor was Jonathan B. Lovelace, at the time a member of the investment banking firm of E. E. MacCrone & Co., which effected the original public distribution of the investment company shares.[196]

The capital structure consisted of preferred stock, later debentures, and a small amount of common stock. All offerings made to the public were in the form of units. The first offering was 50,000 units each consisting of one share of 7% cumulative Class A preferred stock, one share of common stock, and a ten-year option warrant to purchase one share of common stock at $30 a share.[197] These units were offered at $116.50 and netted the investment trust $107, or a net paid-in capital of $5,350,000, which had cost $475,000 in commissions. E. E. MacCrone & Co. made a firm commitment as to only 15,000 of the units distributed and received a gross spread of $9.50 a unit upon the entire offering. It will be observed that there was an equity margin for the preferred stock of only $7 a share and that it was necessary to earn 6½% in order to meet the dividend requirements. When examined as to the soundness of such a high leverage structure, Mr. Lovelace testified:[198]

Q. You thought that was a sound capital structure?

A. I thought it was unsound to the extent of the higher rate of dividends on the net capital received. I thought that was unsound. But I did not have any objection to the warrant picture, and I thought we could gradually correct the other pictures by putting out later issues of stock without a fixed return.

Q. You thought it had too many senior charges?

A. Yes; when the fund owned $107 for each unit and carrying the $7 rate you could not expect to earn a direct return sufficient to carry that.

Q. Did you say that at the time?

A. I think we all discussed it, and we thought that it could be corrected later.

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[195] Op. cit. supra, note 140, at 7001–3, 7011–13. This delay was occasioned by opposition from the New York Stock Exchange and the State of Michigan, which feared that such companies would absorb too much investment capital, and by the general reticence of certain trust companies. (Ibid.)

[196] Op. cit. supra, note 140, at 7000, 7011.

[197] Id., at 7015–17 and Commission's Exhibit No. 669.

[198] Id., at 7328.

Some reduction in the rate of fixed charges was effected some five months later when, on September 29, 1927, Bonbright & Co., Inc. entered into an agreement for the marketing of $5,000,000 of 5% debentures, due in 20 years.[199] Ten-year option warrants for the purchase of ten shares of common stock at prices ranging from $32.50 to $37.50 a share were issued with each $1,000 debenture, and, after the payment of $200,000 underwriting commissions, the investment company netted $4,650,000 from the offering.[200] Total paid-in capital was thereby increased to $10,000,000 and fixed interest and dividend requirements were reduced to 6%. At the same time the leverage for the common stock was increased.

Offerings were again made in February 1928 of 50,000 units of one share of Class B preferred stock (in all respects the same as the Class A) and one share of common stock, under an agency contract with E. E. MacCrone & Co.[201] Sales totaled 10,000 units at the average price of $137.65, from which a commission of $7.50 was paid, and the investment company realized increased capital of $1,301,483. In April of the same year the common stock was increased by 50,000 shares sold under rights given to common shareholders exercisable at $34 a share.[202] The $1,700,000 obtained therefrom, together with another $830,175 from option warrants exercised during the period 1928–1930, created a total net paid-in capital of $13,831,658, at a total cost of $750,000. An additional offering of common shares was made to an affiliated company in the fall of 1933 when it was considered necessary to reorganize.[203]

The price trend of the original unit certificates was almost horizontal until April 1928, when they became exchangeable for share and warrant certificates. At that time the investment trust offered rights to common stockholders, as previously noted. Thereafter the allotment certificates showed a continuous rise until October 1929, when the market value of the component parts was almost $240. Despite this substantial rise in about a year and a half, the market price of the preferred stock sagged to $93.

The sale of this stock in units facilitated the sale of fixed income securities during a period when they were decidedly unpopular and kept them distributed in a form that would command a good price until market appreciation in underlying shares created a more adequate equity backing. This increased backing, which had risen to approximately $200 a preferred share at mid-year of 1929, did not suffice to prevent an unfavorable market trend in the senior stock following the split-up.

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[199] Id., Commission's Exhibit No. 671.

[200] Id., at 7021–2

[201] Reply to the Commission's questionnaire for The Investment Company of America, Pts. II and V.

[202] Ibid.

[203] Ibid.

4. PART-PAID SECURITY ISSUES

In some instances closed-end investment trusts and investment companies of the management type issued their securities upon a part-paid basis. The balance due was usually subject to call, either at specified intervals or at the discretion of the issuer.[204]

The asserted economic justification for the issuance of securities of investment trusts and investment companies upon a part-paid basis was that it was more expedient not to have too much money in the treasury at the inception of the investment company. As investments were made and the portfolio grew, and as more opportunities for investing funds were presented the managers could call in the balance due on the security issues sold and secure additional funds without the necessity of floating a new issue of securities.

As long as the security market continued to rise the investor experienced no inconvenience or uneasiness in the possession of a security which entailed a further investment at a later date. But with a decline in the securities market investors were faced with the necessity of putting up more money for the securities which they purchased on a part-paid basis. Because of the relatively small initial outlay required, purchasers may have overextended themselves. Furthermore, the securities sold in units could not be broken up and the component parts sold separately until the unit had been fully paid for. Meanwhile, the underwriting commission, which was computed upon the price of fully-paid certificates, was usually collected out of the original payment.

In January 1929 Petroleum Corporation of America made its original offering of 3,250,000 common shares at $34 a share, payable $20 in cash and $14 subject to call. Blair & Company, Inc., the sponsor investment bankers distributing the issue, made a firm commitment for only the first payment upon one-fifth of the issue and undertook to use their best efforts to sell the balance of the issue. The underwriters received a commission of $3 a share, or over 9% of the net purchase price. However, the underwriters received this commission upon the payment of the first installment of the purchase price. In addition they received five-year option warrants to purchase 1,625,000 additional shares at $34. Call was made for the balance of $14 a share on June 30, 1929, to be paid on October 1 of that year. At the end of 1929 $1,106,555 remained unpaid to the investment company on the part-paid certificates held by the public and $117,240 was still due at the end of 1930. On January 29, 1936, the shares representing the unpaid balance of about $104,600 were sold at public auction for about $104,000 by the investment company to recover the amounts due.[205]

Selected Industries, Inc.

The bankers offering the shares of Selected Industries, Inc. upon a part-paid basis underwrote the entire purchase price. The collection

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[204] An analogous sales device was the installment investment plan which sold investment trust or investment company shares upon periodical payment bases. However, the shares of closed-end management investment companies were seldom used as the underlying securities for such plans. (See the Commission's report on companies sponsoring installment investment plans.)

[205] For full details see Ch. II of this part of the report, pp. 227–309.

of the unpaid balances due upon the subscriptions proved somewhat difficult, and because of possible hardship on the shareholders the investment company released bankers from their obligation to pay the balance.

Selected Industries, Inc. was organized on December 15, 1928 under the laws of Delaware, at which date it made a public offering of 700,000 allotment certificate units for the gross amount of $70,000,000. Each unit was composed of one share of $5.50 dividend prior preferred stock, one share of common stock, and a perpetual option warrant to purchase one share of common stock at $15 a share.[206] These units were sold for $100 each, of which 50% was payable in cash and the balance subject to call not before April 1, 1929 and not later than January 1, 1931, in amounts not to exceed 25% of the purchase price, and had to be fully paid before they could be split up into the component shares.[207] The issue was underwritten in the full amount of the purchase price by a group of five investment bankers under two agreements dated December 15, 1928, one covering 140,000 units as a joint undertaking, while the other covered 560,000 units for which each banker was liable only to the percentage of his participation, as follows:[208]

	Percent
Chas. D. Barney & Co	30.7
Stone & Webster and Blodget, Inc	23.1
Lehman Bros	19.2
Kidder, Peabody & Co	15.4
Brown Bros. & Co	11.6

The shares were taken down under both agreements in the above proportions, and thereafter no differentiation was made between the obligations under the two contracts. The underwriting fee, of $6 a unit, or a total of $4,200,000, was payable at once out of the original 50% subscription, and the underwriters were to be subrogated to all rights and property in the units for which they should be called upon to make good the calls for the balance of the purchase price.[209] This public distribution was managed by Stone & Webster and Blodget, Inc., as were four trading accounts which were operated in connection with this public offering between December 15, 1928 and September 3, 1929.

From September 3, 1929 through February 18, 1930, Chas. D. Barney & Co. managed three accounts which traded in the 50%- and 75%- paid units.[210] These three accounts were participated in by the sponsor-underwriters in the same proportions as they had in the original underwriting. All purchases were sold back in the open market, although frequently in some other form than that in which the purchase had been made. The account adopted the practice of paying

[206] Reply to the Commission's questionnaire for Selected Industries, Inc., Pt. I.

[207] Ibid.

[208] Ibid.

[209] Ibid. The agreement covering the 560,000 units also provided that the investment company should pay the costs of organization as well as all security issuance and qualifying expenses. (Ibid.)

[210] Derived from supplementary information supplied thhe Commission for Selected Industries, Inc.

up additional assessments, and when such payments resulted in fully paid units, the latter were split up and traded accordingly.[211]

At the time of the public offering a private offering was made of 233,000 packages, consisting of six shares of common stock and two shares of convertible stock (each exchangeable for three shares of common stock at any time), at $85.84 a unit, or for a total of $20,000,-720.[212] All of these packages, representing 466,000 shares of convertible stock, and 1,398,000 shares of common stock (equivalent to a total of 2,796,000 shares of common stock), were subscribed to by the sponsor-underwriters on a 50%-paid basis, with the balance subject to call. In this case, however, deliveries were made of the individual shares represented by the amounts of subscriptions paid.[213] From December 20, 1928 through February 1930, Chas. D. Barney & Co. managed four trading accounts in the common stock. These accounts represented the method by which the sponsor-underwriters chose to distribute the major portion of the common stock of the Corporation which they had purchased privately.[214]

Two calls of $25 each were made upon the publicly distributed units, effective October 1, 1929, and December 31, 1930, respectively. When substantial defaults occurred after the first call was made the investment company gave four extensions, terminating with an extension to October 1, 1930, and entered into agreements with the underwriters extending their guarantees during the same period.[215]

As of January 14, 1931, there were outstanding part-paid allotment certificates representing 57,000 units on which 75% had been paid, and 489 units on which 50% had been paid, representing a total unpaid balance of $1,466,100. On that date it was agreed between the investment company, pursuant to a resolution of its board of directors, and the underwriters that the latter should be released from their obligations to make good the defaulted calls. No rebates or adjustments were made with respect to the commissions for distributing those shares.[216]

In January 1931 the market price of the fully-paid units was around $54, although the net asset coverage was around $118.87. Had the five banker firms been required to pay the total liability of $1,466,100 to the investment company, they would have received allotment certificates, 100%-paid, having a total net asset coverage of approximately $6,912,884.85 and a market value of $3,140,370. It was the position of the investment company that this course would have been unfair to the holders of the part-paid certificates who had failed to make payments when due, and that it would have benefited enormously the banker-sponsors if they had succeeded to the rights of such part-paid certificate holders. During these difficult times the investment company helped the holders to borrow money from the Guaranty Trust Company secured by their part-paid units, to meet the calls. The date of payment was also extended until the end

[211] Ibid. In at least one instance, the investment company repurchased its own stock from a sponsor-underwriter trading account. (Ibid.)

[212] Op. cit. supra, note 206, Pt. V.

[213] Ibid.

[214] Op. cit. supra, note 210.

[215] Op. cit. supra, note 206, Pt. I, and derived from supplementary information supplied the Commission for Tri-Continental Corporation.

[216] Derived from supplementary informations supplied the Commission for Tri-Continental Corporation.

of 1931 when 725 units on which 75% had been paid, and 334 on which only 50% had been paid, were finally canceled.[217]

The experience of this investment company demonstrates the situation which may be presented when installment sales are initiated on a rising market and concluded in a period of depression. Investors, who had already paid $75 for a unit at the final call, were asked for $25 more at a time when fully-paid units were selling in the market at $54.

The use of this distribution scheme placed the management of Selected Industries, Inc., in a difficult position. The investment company held an underwriting guarantee which could be enforced against the sponsors, yet half of the board of directors were representatives of those sponsors. If the investment company enforced the guarantee against the sponsors, it would receive the balance due on the shares but shareholders might have to forfeit the one-half to three-quarters of the purchase price already paid in to the investment company. On the other hand, the guarantee had already run over a year from the date of the first call and the problem was presented whether the sponsors could be expected to consent to an indefinite extension of their obligations.

In connection with this guarantee, the repurchase policy of the investment company in regard to its own securities should also be mentioned.[218] Selected Industries, Inc. made its first call for $25 on October 1, 1929. By the end of that year 93,304 75%-paid units had been repurchased at an average price of $33.03, while no fully paid units were repurchased during that year. In 1930, 121,135 75%-paid units and only 7,863 fully paid units were reacquired. The total cost to the investment company for the repurchase of its own partly paid securities was $8,145,127. About 32% of these units were acquired by private negotiation from the five sponsor banking firms and from one outside stockholder, Vick Financial Corporation.

Shawmut Association

Shawmut Association was organized as a Massachusetts trust on May 21, 1928, to purchase the stocks of New England banks.[219] The sponsors were the National Shawmut Bank, one of the largest commercial banks in New England, and its security affiliate, the Shawmut Corporation. The shares of the investment trust were offered for sale to the shareholders of the bank. No investment was made in the venture directly by the bank which maintained complete control of the investment trust, since all of the trustees were officers and directors of the bank.[220]

The capital structure of this investment trust consisted entirely of common shares, as contrasted with debentures in the structure of Shawmut Bank Investment Trust, another investment trust apparently organized and operated under the same sponsorship.[221] The marketability of the shares was a primary consideration in arriving

[217] Ibid.

[218] Op. cit. supra, note 206, Pt. V.

[219] Op. cit. supra, note 174, at 3349–50, 3355a.

[220] Id., at 3355b–6 and Commission's Exhibit No. 355.

[221] See supra, pp. 907 et seq.

at this one class security structure. Frederick A. Carroll, vice president and trust officer of the National Shawmut Bank testified: [222]

Q. Now, Mr. Carroll, what were the facts which led to the formation of an additional affiliate to the Investment Trust one year and three months after you launched the Shawmut Bank Investment Trust? What was the distinction you had in mind between those two, and what were the reasons you did not expand the first, but formed a new one?

A. Well, substantially the same reasons existed for the formation of the Shawmut Association as I recited existed for the formation of the Shawmut Bank Investment Trust. There is, of course, one distinction, that the Bank did not make any investment in the Shawmut Association. I think the reason that it was given the form that it had as contrasted with the S. B. I. T. was that since it was entirely stock ownership it was more consistent with the demands of the investment public at that time, who wanted stock ownership rather than a note with a kicker. You will remember this is in 1928, and the public were pretty much stock-minded at that time, and it was more like the investment trusts then in existence and it gave the investor an opportunity to invest in a cross section of equities and some bonds under the management of the Shawmut Bank in which it had faith, and the previous one had been successful up to that time.

The principal offering consisted of 300,000 shares for which rights expiring June 5, 1928, were given to the stockholders of the National Shawmut Bank. These rights were exercisable at $50 a share, of which $20 was to be paid in cash and the balance was subject to call. The Shawmut Corporation, the security affiliate of the bank which had the same stockholders as the bank, purchased 175,000 of the shares of the investment trust not taken down under those rights.[223] The management group of the National Shawmut Bank purchased another 20,000 shares at $51.50 a share, of which $21.50 was paid in cash and the balance was subject to call. There were no distribution charges upon either of the foregoing blocks which brought the investment trust a total of $6,430,000.[224]

Only 80,000 shares were distributed publicly by the Shawmut Corporation for which it received a commission of $80,000. As the public offering price was $52.50 a share, of which $22.50 was paid in cash, the investment trust received $1,720,000 net from this operation and its total paid-in assets at that time were $8,150,000.[225]

A further refinement of the part-paid plan of security issue was provided by the offering to the management group.[226] While that group ostensibly paid $21.50 per share in cash, even this initial payment was made largely upon credit extended by the investment trust. Two plans were made available by the Shawmut Association to these subscribers. Under one plan only $3.50 a share was payable in cash and the balance of $18 a share was advanced by the investment trust upon the security of the shares so purchased. The other plan permitted the investment trust to advance the entire payment upon the deposit of acceptable collateral security, including the shares so sub-

[222] Op. cit. supra, note 174, at 3345–6.
[223] Id., at 3357–60.
[224] Ibid.
[225] Ibid.
[226] Reply to the Commission's questionnaire for Shawmut Association, Pt. II.

scribed, at all times possessing a market value equal to $25 for each share purchased. The amount so advanced was repaid with but slight loss to Shawmut Association.[227] This situation may have influenced the policy adopted with reference to the $30 balance subject to call upon the shares issued and outstanding. In November 1928, Shawmut Association canceled its claim for this balance, amounting to approximately $12,000,000, and declared the stock fully paid.[228] According to the testimony of Mr. Carroll, although there would have been little difficulty in collecting this call, this cancelation was made chiefly so that the stock might be listed as fully paid upon the Boston Stock Exchange.[229] The underwriting fee, although comparatively small, was based upon the value of the fully paid stock. No adjustment of this fee was made when the unpaid balance was canceled.

5. MARKET OPERATIONS IN CONNECTION WITH DISTRIBUTION

In order to facilitate the distribution of the shares of investment trusts and investment companies by public offerings it was important that some market be established and maintained at or above the offering price. In the case of investment company securities with only an over-the-counter market, a market was maintained merely by maintaining a bid price at the desired level. But where the shares comprising the public offering were listed upon a stock exchange, a trading account in the security was usually operated to "stabilize" or to increase the market price.[230] This function was customarily performed by the underwriters, who presumably considered the probable cost of the operation in arriving at the underwriting commission.

The extent of the trading necessary to maintain a market for a listed or unlisted security depended upon the quality of the issue and general market conditions. In January 1929 when Blair & Company, Inc., offered the shares of Petroleum Corporation of America the market was generally receptive to issues of investment trusts and investment companies, yet the investment banker repurchased approximately 25% of the 3,250,000 part-paid shares marketed at that time in order to make the issue a success, while 570,600 shares were purchased by insiders.[231]

Similarly, when Italian Superpower Corporation marketed an additional $2,000,000 of its debentures in July of 1929, the investment company entered upon an extensive repurchase program, undertook the repurchase of $2,000,000 of its debentures and increased its offering through Bonbright & Co., Inc., and Field, Glore & Co., Inc., the American sponsors, to $4,000,000 of debentures. The results were that those bankers did not have the risk and expense of maintaining the market, although they received a 5% selling commission, and the amount of the offering made through them was doubled.[232]

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[227] Derived from supplementary information supplied the Commission for Shawmut Association.

[228] Op. cit. supra, note 174, at 3361.

[229] Ibid.

[230] For relative importance of exchange and over-the-counter markets see Pt. Two (House Doc. No. 70, 76th Cong.), Ch. IV, pp. 279–85.

[231] See Ch. II of this part of the report, pp. 227–308.

[232] See infra, pp. 931–2.

In connection with the original offering of Ungerleider Financial Corporation a contract dated May 8, and amended May 13, 1929, was entered into between Samuel Ungerleider & Company, investment bankers and brokers, and the investment company. This was primarily an agency contract whereby the banker and his associates agreed to use their best efforts to place upward of 500,000 common shares at the public offering price of $52 a share. The investment company agreed to repurchase its shares at not to exceed $50 a share, the paid-in value, in cooperation with the selling group, which in turn agreed with Samuel Ungerleider & Company, by a separate contract, to take back all shares repurchased to maintain a market. On December 11, 1929 the public offering was terminated and thereafter the shares were first listed upon the New York Curb Exchange. At that date the investment company had repurchased 222,359 shares at the average price of approximately $49 a share, or a total of $10,992,859.16, of which only 72,549 shares were taken back by the selling group at $50 a share for a total of $3,627,450. By these repurchases the investment company in effect maintained the market in its own shares for its bankers during the course of the public offering. Later Ungerleider Financial Corporation repurchased an additional 41,768 shares for a grand total of $13,205,575.76, leaving 244,400 shares outstanding for which the investment company had received a total consideration of $13,205,575.[233]

The phenomenal expansion of the United Founders Corporation group of investment companies, from paid-in resources possessed by three companies at the end of November 1927 of about $77,870,000 (including $6,817,000 of intercompany holdings) to paid-in resources possessed by 13 companies at the end of 1929 of $686,165,000 (including $182,338,000 of intercompany holdings),[234] was in part the result of distribution based upon reports of substantial profits which in turn depended upon the distribution itself. Although it was not revealed to prospective investors, these profits were derived primarily from the purchase, at an inside price, of the securities issued by the various companies comprising the group and their resale to the public or to affiliated companies.[235]

At the organization of each new investment company large blocks of its securities would be allotted to the other investment companies in the group at prices substantially below the prices at which like securities would shortly thereafter be distributed to the public. During 1928 and 1929 the aggregate market premium was $91,743,900 in excess of the $76,800,000 of assets paid in by the original subscribers.[236] Such shares as well as participations in subsequent issues acquired by member companies in the group, would be resold at increased prices either to the public or to other companies in the group and such transactions constituted the primary over-the-counter market in the shares.[237] The "profits" realized by companies of the group exclu-

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[233] See infra, pp. 937 et seq.

[234] Public Examination, American General Corporation et al., Commission's Exhibits Nos. 3400 (p. 4) 3424–A–1, and 3424–C–1.

[235] For full details of these practices see Ch. VI of this part of the report, Sec. III.

[236] Op. cit. supra, note 234, Commission's Exhibit No. 3739.

[237] In one or two instances these issues made a complete circuit of the investment companies in the group and returned to the original subscribers at a price substantially in excess of the original subscription price.

sively from transactions in their shares and shares of other allied companies, which in turn helped to maintain higher prices for their own security issues, was $4,275,000 in 1928 and $36,288,000 in 1929 and for the latter year such profits comprised about 95% of the entire published profits of the group.[238]

Another investment company which bore a part of the expense of supporting the market for its shares was Iroquois Share Corporation[239] organized on January 14, 1929, under the laws of New York[240] by O'Brian, Potter & Stafford, members of the New York Stock Exchange, with principal offices in Buffalo, New York. This investment company was organized at the instance of a number of banks in Western New York which were clients of the sponsor firm, and the public offering, which was made through that sponsor, was marketed substantially to customers of those banks.[241]

The public offering consisted of 100,000 shares of common stock at $21.50 a share. The commission of $1.50 a share, or a total of $150,000, constituted an underwriting commission of approximately 7% of the $2,150,000 gross proceeds.[242] That the terms of the underwriting contract were dictated by the sponsor was admitted by Walter F. Stafford, at the time a member of that firm and president of Iroquois Share Corporation.[243]

In July 1929 the holder of every three shares of Iroquois Share Corporation stock was permitted to purchase one additional share at $32.50 per share, so that 33,334 new shares were issued which netted the investment company $1,083,355 additional capital.[244] In April 1930 an exchange of 29,418.2 shares of Iroquois Share Corporation stock was made for all of the shares of Williamsville Share Corporation, another investment company, resulting in additional capital of $624,339,[245] so that the entire contributed capital was some $3,707,694.[246]

In support of the marketing of the shares of the investment company the sponsor engaged in trading operations wherein it bought and sold these shares.[247] When these operations were terminated in February 1930 the account was short 4,900 shares at $15.73 a share while Iroquois Share Corporation was long 4,800 of its own shares at $14.50 a share.[248]

The investment company sold its 4,800 shares to the sponsor at $15 a share,[249] or at a profit of 50¢ a share to the investment company and a profit of 73¢ a share to the sponsor. However, the

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[238] Op. cit. supra, note 234, Commission's Exhibit No. 3732. These figures contrast with total net realized profits by the group through the sale of securities of $7,292,000 in 1928 and $38,559,000 in 1929. (Ibid.) In the years 1931 to 1935 the losses from sales of and write downs upon securities of the companies allied to the United Founders Corporation group aggregated $114,600,000.

[239] For detailed story of this company see Ch. II of this part of the report, pp. 51–76.

[240] Reply to the Commission's questionnaire for Iroquois Share Corporation, Pt. I.

[241] Public Examination, Iroquois Share Corporation, at 13933, 13941.

[242] Id., at 13961 and Commission's Exhibit No. 1394.

[243] Id., at 13939.

[244] Id., at 13944–5, 13960.

[245] Id., at 13945–6.

[246] Id., at 13946 and Commission's Exhibit No. 1422.

[247] Id., at 14064.

[248] Id., Commission's Exhibits Nos. 1417, 1418.

[249] Ibid.

market price at the time was 17–17¼ and the asset value was higher than the sale price to O'Brian, Potter & Stafford.[250]

International Superpower Corporation

It was of course desirable, from the viewpoint of the bankers underwriting an issue, to conduct their market operations as profitably as possible. This was accomplished in part by Calvin Bullock, the sponsor of International Superpower Corporation, by the use of short-term option warrants.

International Superpower Corporation was organized on September 27, 1928, by Calvin Bullock, distributor of investment trust shares.[251] The original underwriting agreement was entered into by the investment company and Calvin Bullock on October 15, 1928, at which time the board of directors of the former was comprised entirely of representatives of the sponsor.[252] When new directors were added to the board the underwriting agreement had already been entered into.[253]

By the terms of the underwriting agreement the sponsor was committed to buy 100,000 shares of the common stock of the investment company at $44 a share and to offer them to the public at $48 a share.[254] In addition, this agreement gave the sponsor a first call as underwriter upon any future issues of the investment company for a term of ten years and also provided that Calvin Bullock should receive five-year options for 20% of all offerings made during that period, exercisable at the public offering price. Accordingly, a five-year option was given for 25,000 shares by virtue of the original underwriting of 100,000 shares, the effect of which was to compute the option upon both the offering and the option itself.[255] The underwriting agreement was amended on October 25, 1928, by cutting the commitment to 50,000 shares and the option to 12,500 shares.[256]

From January 11, 1929, to June 22, 1929, a series of agreements was entered into between the same parties, by the terms of which Calvin Bullock underwrote 180,000 additional shares at prices ranging from $47 to $56.25 a share to be offered at prices ranging from $41.50 to $62.25 a share.[257] Five-year options, computed as aforesaid, were granted to Calvin Bullock in addition to the commission which ranged from $4.50 to $6.00 a share.[258]

Up to this time the investment company had distributed 230,000 shares of its common stock at prices which netted it $11,412,825, at

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[250] Ibid. Mr. Stafford stated in a letter dated February 21, 1930, to Frederick C. Stevens, a member of the sponsor firm and of the executive committee of the investment company, as follows (id., Commission's Exhibit No. 268):

> It occurred to me that it might be difficult to explain to the Board of Directors if anybody saw fit to inquire why we had sold stock at 15 when the market was 17 to ¼. However, this transaction having been closed and the stock having been sold, by the firm at 15.73, in view of the fact that the firm has maintained the market and been successful in advancing it, I think that we can satisfy any inquiring director.

[251] Reply to Commission's questionnaire for International Superpower Corporation, Pt. I.

[252] Public Examination, Calvin Bullock Group, at 4027.

[253] Id., at 3998–9.

[254] Id., Commission's Exhibit No. 397.

[255] Id., at 3992.

[256] Op. cit. supra, note 251, Pt. I.

[257] Ibid.

[258] Ibid.

an underwriting cost of $1,102,500, exclusive of the option warrants which were never exercised in spite of favorable market conditions.[259] The underwriting commission ranged from 9% to 11%, while Hugh Bullock testified that the formula was expected to yield in the neighborhood of 10%.[260] Thereafter the shares of the investment company were marketed by the granting of short-term option warrants to Calvin Bullock, acting for a syndicate and individually, as follows:

On July 1, 1929, Calvin Bullock agreed to pay to the investment company $15,000 for which the investment company agreed to issue options to that sponsor for 40,000 shares of its common stock.[261] One block of 20,000 shares could be called for within three months at $60 a share and the other block of 20,000 shares was available for six months at $70 a share.[262] All of the options were exercised during a period when the market price for the stock ranged from $77 to $90.

On August 1, 1929, three-month options for 40,000 more shares were sold to Calvin Bullock for $20,000.[263] This consideration was not paid until 1932, when International Superpower Corporation was merged with Bullock Fund, Ltd. These options called for blocks of 10,000 shares at 75, 77, 83, and 85, respectively. Only the first 10,000 shares were taken down during a period when the market was around 88.[264] In both instances Calvin Bullock received five-year option warrants as provided under the original underwriting agreement. By this device the capital of the investment company was increased by $3,350,000, while the profits to the syndicate were limited only by the market price.

In order to achieve this additional distribution it was necessary for the syndicate to sell 115,000 shares through dealers and 120,000 shares upon the exchange and to purchase about 151,000 shares upon the exchange.[265] The active trading was conducted primarily upon the New York Curb Exchange.[266]

The options were granted at prices which were close to or below the market price. The success of the financing depended upon the market and, perhaps more important, the ability of the syndicate to handle the market successfully. Hugh Bullock denied that purchases were made of the shares on the market to cause an increase in market price so that sales could be made off the market at such advances.[267] However, trading operations conducted by the syndicate in two accounts involved 37% of the volume and 77% of the number of transactions upon the New York Curb Exchange in those shares.[268] Such activities were anticipated in the creation of the syndicate for the purpose of maintaining the market.[269] Because of the upward price movement, the stock, at the peak, was almost 50% more than its

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[259] Id., Pt. V.
[260] Op. cit. supra, note 252, at 4038.
[261] Op. cit. supra, note 251, Pt. I.
[262] Ibid.
[263] Ibid.
[264] Id., Pt. V.
[265] Op. cit. supra, note 252, at 4045–6.
[266] Id., at 4057.
[267] Id., at 4049.
[268] Id., at 4064.
[269] Id., at 4066.

liquidating value. Hugh Bullock testified with respect to the second syndicate account.[270]

Q. So that you wouldn't have any doubt in your mind that the purchase of 107,000 shares on the open market, and the sale only of 55,000 shares, had an influence in raising the price of the stock on the market?

A. Not particularly. By that I mean, it had no particular influence.

Q. The effect of it would be to raise the price, would it not?

A. When there are more buyers than sellers, the price goes up, but as to how much it goes up is another matter.

The total profit from the two syndicate accounts was about $350,000. Thereafter, Calvin Bullock engaged in continued efforts to support the market in the shares of the investment company and suffered losses which more than wiped out this profit.[271]

The sale of the shares of an investment company under an option arrangement may be likened to "best efforts" underwriting contracts in that there is no firm commitment to buy a fixed amount of shares at a specified price. However, in the best effort contracts, the underwriter or the distributor sold shares as an agent for the issuing investment company at a fixed price and for a predetermined commission. Also, the absence of a firm commitment was usually reflected in a reduced loading charge. By the use of options in connection with the distribution of investment company shares the underwriter or distributor acted as principal, and the prices paid by new shareholders, which determined the sales profits were fixed by the market price of the stock which might be affected by the market operations of the underwriter.

The Goldman Sachs Trading Corporation

An example of "over-allotment" or overselling of investment company shares on a stock exchange in connection with an original offering is furnished by The Goldman Sachs Trading Corporation.

The Goldman Sachs Trading Corporation was organized on December 4, 1928, by the brokerage and investment banking firm of Goldman, Sachs & Co.[272] This sponsor exercised complete control over the affairs of the investment company at all times until Atlas Corporation formally assumed control on April 17, 1933, on which date the name of The Goldman Sachs Trading Corporation was changed to Pacific Eastern Corporation.[273]

The original offering of the shares of The Goldman Sachs Trading Corporation consisted of 1,000,000 shares of common stock which were underwritten by Goldman, Sachs & Co. for a cash consideration of $100,000,000. As stated in the original offering circular, 100,000 shares were retained by this sponsor and the balance of 900,000 shares was distributed through a selling group at $104 a share. The $4 spread was allocated $2 to Goldman, Sachs & Co. and $2 to the selling group. Goldman, Sachs & Co. also took a par-

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[270] Id., at 4051.

[271] Id., at 4101.

[272] Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibits Nos. 1652, 1654.

[273] Id., at 15862–4.

ticipation consisting of 83,108 shares in the selling group for disposal through their retail sales department.[274]

In addition to the $10,000,000 investment purchase by Goldman, Sachs & Co. and allotments for some $6,000,000 of the shares to the members of that firm and their families, other subscriptions to close business associates brought such private placements to at least $50,000,000. These sales were made at $102 net per share by constituting them a "preferred list" and including them among the participants in the selling group.[275]

This offering was oversubscribed at least twice [276] and in making allotments, 50,000 shares were oversold. The nature of this situation was explained in the further testimony of Waddill Catchings: [277]

Q. In connection with the distribution of these securities through the selling groups Goldman, Sachs & Co. had an account, isn't that so, in which there was an overallotment of shares?

A. In the original sale of securities Goldman, Sachs & Co. sold 1,050,000 shares although it had only 1,000,000 shares that they purchased from the company. They oversold 50,000 shares.

Q. And that was an overallotment by Goldman, Sachs, the banking firm?

A. That is correct.

Q. Overallotment means simply, does it not, that they confirmed orders to purchase, or made contracts to sell 50,000 shares more than the original 1,000,-000 that was issued; isn't that true?

A. That is correct. The expression "overallotment" is made as you are allotting to the subscribers. It is strictly an oversale. You sell that amount short, so to speak.

Q. It corresponds to a short sale?

A. It is actually a short sale. An overallotment is a short sale.

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[274] Id., Commission's Exhibit Nos. 1655, 1656, and 1659.

[275] Id., at 15924–8. Shares of The Goldman Sachs Trading Corporation were sold to the following purchasers who were not dealers in securities and whose individual allotments in the selling group each totaled 5,000 shares or more (id., Commission's Exhibit 1660):

	Shares
B. M. Baruch	5, 000
Conway Co	10, 000
Delmar Capital Corp	75, 000
Dr. John T. Dorrance and Wife	11, 000
Goldman, Sachs & Co. employees	14, 593
Goldschmidt Trust	6, 250
Georgette Goldschmidt	1, 750
The Howard Co	15, 000
Jackson Johnson	10, 000
Kleinwort, Sons & Co	21, 500
Albert Lasker	10, 000
Eugene Meyer, Jr	20, 000
Mudge-Weir Securities Corp	5, 000
McKenna Corp	7, 500
Conde Nast	20, 000
Wm. C. Potter & Associates	5, 400
F. C. Rand	10, 000
George F. Rand	7, 500
Raywarn Corp	10, 000
Renraw, Inc	30, 000
Harry Warner & Associates	5, 000
Mrs. Alice G. Sachs	7, 508
E. H. Watson	10, 000
Westover Trading Co	5, 000
Ernest L. Woodward	20, 000
	343, 001

[276] Derived from supplementary information supplied the Commission for The Goldman Sachs Trading Corporation.

[277] Op. cit. supra, note 272, at 15935–7.

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Q. That is right. You haven't the securities and you hope to be able to get them.

A. Not only hope, you have to get them.

Q. Or else—well, there isn't any "else."

A. There isn't any "else." You go bankrupt, if you are responsible in business.

Q. So you had a position where Goldman, Sachs & Co. overallotted 50,000 shares, and where they had to acquire these securities?

A. They sold 950,000 shares. They had to acquire 50,000 in the market, or they had to use part of the 100,000 shares they had bought for investment. In order to retain the 100,000 shares they bought for investment, they would have to purchase 50,000 shares from somebody else.

Inasmuch as Goldman, Sachs & Co. felt bound to retain its publicized position of 100,000 shares and its participation in the selling group evidently was earmarked for resale to customers of that firm, this overallotment of 50,000 shares had to be covered by purchases in the open market or by private negotiations.

From December 10, 1928, the effective date of admission of the stock of The Goldman Sachs Trading Corporation to trading on the New York Curb Exchange, through December 29, 1928, Goldman, Sachs & Co. covered 28,800 shares of its overallotment or short position through purchases in the open market. The bankers' purchases represented two-thirds of the volume traded on the New York Curb Exchange on the days upon which such purchases were made, and constituted 40% of the total volume over the period. Purchases during January 1929 in the open market brought the total stock so acquired to 32,841 shares, at an average cost of $112.09 per share.[278]

Purchases by private negotiation accounted for 14,822 shares of the overallotment at an average cost of $118.34 per share.[279] Of these repurchases, made from December 10, 1928, to January 10, 1929, inclusive, the great bulk were negotiated with three members of the "preferred list" who were also included in the selling group. Accordingly, within two weeks of the delivery date (January 4, 1929) of temporary certificates or of interim receipts, profits of as much as 17¾ points were made.[280]

While the covering of the overallotment was made at a considerable expense to Goldman, Sachs & Co., this operation took the place of the trading acount which customarily accompanied the original distribution of such substantial issues. However, after deducting

[278] Id., at 15919 and Commission's Exhibit No. 1661.

[279] Id., Commission's Exhibit No. 1661. The remaining 2,337 shares were transferred from the original purchase account of Goldman, Sachs & Co. (Ibid.)

[280] Direct transactions with members of the "preferred list" were as follows (op. cit. supra, note 272, Commission's Exhibits Nos. 1660, 1661) :

Name of seller	Shares allotted	Shares sold	Sales prices	Gross profits from shares sold	Dates of sales
Delmar Capital Corp	75,000	8,000	118	$128,000	Jan. 7, 1929
Kleinwort, Sons & Co	21,500	655	119	11,135	Jan. 9, 1929
		265	119	4,505	Jan. 10, 1929
McKenna Corporation	7,500	1,552	119¾	27,548	Jan. 2, 1929
		3,450	119½	60,375	Jan. 10, 1929
Total	104,000	13,922	----------	$231,563	

$478,227.50 net trading loss in covering the overallotment and other expenses of $303,000, the net underwriting and selling group profit realized by Goldman, Sachs & Co. amounted to $1,184,988.50.[281]

The prospectus used by Goldman, Sachs & Co. had represented that The Goldman Sachs Trading Corporation would have a capitalization of $100,000,000 and would issue 1,000,000 shares of its capital stock and on December 7, 1928, the New York Curb Exchange admitted to trading, on a when-as-and-if-issued basis, the 1,000,000 shares of capital stock of The Goldman Sachs Trading Corporation which had been sold to Goldman, Sachs & Co.[282] The certificate of incorporation of The Goldman Sachs Trading Corporation specifically denied to its stockholders the preemptive right to purchase any additional offerings of the company's stock and this fact was publicized in the prospectus.[283] However, the New York Curb Exchange, as a prerequisite to the listing of the 1,000,000 shares of the company's stock then to be issued by the investment company, required the investment company to adopt a resolution to the effect that stockholders were to be afforded an opportunity to subscribe to additional issues of stock for cash unless, in the judgment of the company's board of directors, it was not feasible to do so. This resolution was adopted by the Board of Directors of The Goldman Sachs Trading Corporation on December 14, 1928.[284]

On December 10, 1928, the first day of trading in the stock of The Goldman Sachs Trading Corporation, the stock opened at a price of $108 a share and by December 31, 1928, was selling for $117 a share.[285] At this point the investment company, without the knowledge of either the New York Curb Exchange or the existing public holders of its stock, commenced to sell its own shares on the New York Curb Exchange. At this time the investment company possessed none of its own stock other than its authorized but unissued shares in excess of the 1,000,000 shares it had already issued. Furthermore, the board of directors of the investment company had not in any corporate resolution approved the issuance of more than 1,000,000 shares of its capital stock, nor had the Curb Exchange admitted more than the original 1,000,000 shares of the company's stock to trading in its market. As a consequence, the corporation was placed in a position of selling its own stock "short," an activity which Waddill Catchings, the president of The Goldman Sachs Trading Corporation and a partner in Goldman, Sachs & Co., conceded might have a depressing effect on the market price of the company's stock:[286]

Q. You believe, do you not, Mr. Catchings, and this is back of the arguments of all the disciples of short selling, that short selling has a propensity or the effect of preventing substantial rises in price in the market——

A. I am not a disciple of short selling.

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[281] Op. cit. supra, note 272, Commission's Exhibit No. 1661.

[282] Op. cit. supra, note 272, Commission's Exhibits Nos. 1656 and 1658. Although only 1,000,000 shares were to be issued, the authorized capitalization of The Goldman Sachs Trading Corporation was 2,500,000 shares. (Id., Commission's Exhibit No. 1652.)

[283] Op. cit. supra, note 272, Commission's Exhibit No. 1652.

[284] Id., at 15919–23 and op. cit. supra, note 276.

[285] Op. cit. supra, note 272, at 15937–8 and 15914.

[286] Id., at 15940–2.

Q. You will agree with their argument?

A. I don't know about that. I am just giving you the fact as best I can.

Q. Might not an offering of 125,000 shares of stock tend to check a rise in price?

A. I should certainly think it might.

In its short-selling activities the position of The Goldman Sachs Trading Corporation was such that it could suffer no loss. If the market price of its stock declined the corporation could cover its short position by purchases of its stock in the market at lower prices than those at which it had sold the stock. In this situation the corporation would derive a profit at the expense of its own stockholders who had sold their shares to the corporation. If the market price of its stock rose the directors of the corporation could cover its short position by approving the issuance of additional shares of its authorized but unissued stock. In this case, however, the existing stockholders would be deprived of the preemptive right which the corporation had agreed with the New York Curb Exchange to accord to its stockholders where feasible.

Moreover, the short selling activities of The Goldman Sachs Trading Corporation might have been advantageous to its sponsor, Goldman, Sachs & Co. The short selling operations of The Goldman Sachs Trading Corporation were conducted largely during the period when Goldman, Sachs & Co. was engaged in covering its overallotment and quite likely served to retard the advance in the market price of the company's stock.[287]

Between December 31, 1928 and February 3, 1929, The Goldman Sachs Trading Corporation sold "short" 125,000 shares of its own stock at an average price of $126.21 per share for total proceeds in excess of $15,000,000. These sales by the corporation constituted 69% of the total transactions in its stock on the New York Curb Exchange.[288]

On February 3, 1929, the New York Curb Exchange became aware of the short-selling activities of The Goldman Sachs Trading Corporation and requested the corporation to cease selling its stock. On this point Mr. Catchings testified:[289]

Q. In any event you sold pursuant to the [the prospectus] 1,000,000 shares and then sold 125,000 shares technically short, because you physically didn't have possession of those securities, and you raised an additional $15,000,000?

A. They were authorized to be issued. The only thing is that they were not at the time listed, but they were listed there on February 3rd.

Q. This stock was admitted to trading on the New York Curb Exchange. Did the Curb Exchange have anything to say about The Goldman Sachs Trading Corporation who announced that they were going to sell a million shares and their listing application disclosed only a million shares when the Curb Exchange found that The Goldman Sachs Trading Corporation was selling additional shares in the open market?

A. Yes; the Curb Exchange said that they didn't want us to do it and that is the reason we stopped at 125,000.

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[287] Mr. Catchings, however, denied that the selling activities of The Goldman Sachs Trading Corporation were intended to depress the market price of its stock in order to enable Goldman, Sachs & Co. to cover its over-allotment at lowest possible prices in the market. (Op. cit. supra, note 272, at 15939 and 15941.)

[288] Op. cit. supra, note 272, at 15909, and Commission's Exhibit No. 1665.

[289] Id., at 15917.

On February 3, 1929, the additional shares of the stock of The Goldman Sachs Trading Corporation which it had sold short were listed for trading on the New York Curb Exchange and on February 5, 1929, the Board of directors of the corporation for the first time authorized the issuance of an additional 125,000 shares of the company's stock to cover its short position in the market.[290] The resolution authorizing an issuance of the shares further stated that "it has been deemed unprofitable to sell such additional shares for such price by first offering them to the outstanding stockholders of the corporation."[291] On February 5, 1929, the market price of the company's stock was 179⅝. Had the company attempted to cover its short position by market purchases it would have suffered a trading loss of approximately $6,677,000.

From the standpoint of the purchasers of the original 1,000,000 shares of the corporation, two aspects of the undisclosed additional selling of its shares by the corporation must be noted. In the first place the actual capitalization of the corporation became different from that which the prospectus represented the corporation would initially possess. The prospectus did not inform the stockholders that the corporation intended to sell additional shares in the market if market conditions justified such a step. On this point Mr. Catchings testified:[292]

Q. * * * Now in your offering circular, Mr. Catchings, you stated "Capitalization, Capital Stock, no par value. Authorized—2,500,000 shares; to be presently issued 1,000,000 shares." And we find that before the delivery date [of the original 1,000,000 shares offered by the corporation], January 4, 1929, that not only was that 1,000,000 shares sold, but Goldman Sachs Trading Corporation was selling stock on The Exchange and over-the-counter in addition to that million shares; isn't that so?

A. That is correct. It began on the 30th or 31st of December 1928.

Q. Now it is one thing for a person to be a stockholder in a $100,000,000 investment company and another thing for him to be a stockholder in an investment company that has $115,000,000; and it is another thing being a stockholder in a corporation that has $234,000,000 and it is another thing to be a stockholder in a corporation that has $329,000,000, isn't it?

A. I don't know just what you mean by "another thing," but obviously the corporations are different * * *.

* * * * * * *

Q. So that within a short time anyway you decided to increase the size of the funds from a hundred to one hundred and fifteen million.

A. Yes; and it might have been more. You know, it wasn't * * *.

Q. A fixed amount. If you could have sold more you would have sold more?

A. No, I don't think that is right. More could have been sold but actually 125,000 were sold.

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Q. So from that aspect the only limitation you had on the amount of stock you could sell that way was the original authorized 2,500,000 shares?

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[290] Id., at 15912 and 15917.

[291] Minutes of the meeting of the board of directors of The Goldman Sachs Trading Corporation held on February 5, 1929.

[292] Op. cit. supra, note 272, at 15910–11 and 15914–15.

A. Yes; and if you had sold that amount you probably could have gotten the consent from the stockholders to issue more; so that was the only limit without the approval of the stockholders.

Q. Secondly, there was no statement in the prospectus that it was contemplated that if the market was good they would immediately sell more stock?

A. You have got a copy of the prospectus right there.

In the second place, although the original stockholders derived the advantage through their aliquot interest in the corporate assets of these additional sales of the corporation's stock at prices higher than the original offering price, they were deprived of the personal profits which might have accrued to them if the preemptive right had been accorded to them. Mr. Catchings testified: [293]

Q. * * * Now in this case where the 125,000 additional shares were sold for approximately $15,000,000, the market during the time ranged from 117 you say to ultimately 139. Now if pursuant to this resolution the stockholders are given their preemptive right, they would have gotten the stock at $100 and they would have realized a profit of $17 to $39 a share.

A. They got it anyhow, they realized it through the corporation.

Q. That is they realized it through their aliquot participation in the corporation.

A. That is correct.

Q. But here was an individual who was a stockholder, and as far as his personally realizing it as counter distinguished from the investment trust, he was deprived of that opportunity, isn't that so?

A. I don't believe that, under the circumstances, it would have been feasible to offer stock to the stockholders at $100 and grant them a preemptive right. The whole purpose of the transaction would have been defeated if that had been done.

E. Underwriting Benefits and Profits

The influence and control of investment bankers over investment trusts and investment companies was probably most effective in determining the amount and character of compensation they should receive for underwriting the issues of such enterprises. This compensation took a variety of forms, such as cash, option warrants, free stock, etc.[294] Out of a total of 204 public offerings through the aid of bankers during 1927–1935, options were given to the bankers in 53 cases and securities were given in three cases, without the payment of cash or property therefor. This practice was particularly widespread in 1928 and 1929 when bankers received options in 53 out of 138 issues, including 31 out of 51 common stock issues. In addition, more indirect benefits naturally arose from the control of the substantial funds possessed by closed-end management investment companies. Furthermore, this remuneration was sometimes given for management and other services, as well as for marketing the issues of the investment enterprise. It was accordingly difficult to arrive at the true value of the benefits received and to allocate them to the various functions for the purposes of any comprehensive analysis of underwriting costs.

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[293] Id., at 15921–2.

[294] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 203–6, and Table 66.

The cash compensation, based upon the published loading charge,[295] was itself a sizable amount. It was reported by 163 closed-end management investment companies proper and 21 management investment holding companies that they paid $116,519,000 for the marketing of their securities for a total of $2,109,000,000 so that the selling load averaged about 5.5% of the offering price and 5.8% of the net proceeds to the investment companies.[296] Furthermore, such loads were sometimes computed upon shares sold upon part-paid bases, the unpaid balances of which were subject to cancelation,[297] while the possibility of pyramiding selling commissions through intercompany holdings, without adding any new money to the industry, also presented itself.

As has been indicated, J. & W. Seligman & Company, the investment bankers for Tri-Continental Corporation, received $3,000,000 for marketing the $53,000,000 issues of Tri-Continental Corporation but received $7,000,000 for marketing in August 1929 the $57,000,000 of new securities issued by Tri-Continental Allied Company, Inc., or a load increase from 6% to 14% of the net proceeds. Option warrants paid by Tri-Continental Corporation as added compensation for marketing its shares were largely offset by sales assistance derived from option warrants given by Tri-Continental Allied Company, Inc., for the same general purposes.[298]

Similarly, Petroleum Corporation of America [299] was organized in January 1929 by Blair & Company, Inc., investment bankers. The bankers agreed to underwrite 650,000 shares, to be sold to the public at $34 a share—$20 in cash and $14 subject to call, by a firm commitment at $31 a share, and to "use their best efforts" to procure purchasers for an additional 2,600,000 shares on which they would also receive a commission of $3 a share.

The total underwriting compensation thus amounted to $9,750,000, or over 8% of the net proceeds to the investment company. Although the bankers had a firm obligation on only one-fifth of the entire issue,[300] they were entitled to the full underwriting commission upon the payment of only $20 of the $34 a share. The obligation to collect the additional $14 per share from the purchasers, rested wholly on the investment company. On June 30, 1929, call was made for the $14 balance, to be paid the following October 1, 1929. At the end of that year $1,106,555 remained unpaid and $117,240 was still unpaid at the end of 1930.[301] On January 29, 1936, the shares representing the unpaid balance were sold for about $104,600 at public auction by the corporation to recover the calls yet due.

In addition to this cash compensation the bankers also received five-year option warrants to buy 1,625,000 additional shares of stock at $34 a share. Of these 1,625,000 warrants, 50,000 were allocated

[295] For a discussion of the computation of the published loading charge see Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 203–6.

[296] Ibid., and Table 67. The average rate of compensation for the public distribution of only the closed-end management investment companies proper was the same. (Ibid.)

[297] See supra, pp. 912 et seq.

[298] For further details see supra, pp. 885 et seq.

[299] For further details see Ch. II of this part of the report, supra, pp. 227–309.

[300] Public Examination, Petroleum Corporation of America, at 2923–6.

[301] Id., at 2929.

for management.[302] These warrants, exercisable at the offering price, clearly had substantial market value during the latter part of 1929. As late as 1930, the warrants sold for as high as $5⅞ per warrant or $9,500,000 for the total block.[303] Blair & Company, Inc., as the syndicate manager, sold 201,700 option warrants for a total of $571,425.[304] Apparently no further attempts were made to sell warrants during the period of distribution because such a procedure would have interfered with the distribution program.[305] None of the option warrants was ever exercised.[306]

Italian Superpower Corporation

Yet another illustration of extensive selling compensation to the sponsor-distributor is provided by Italian Superpower Corporation.

On January 19, 1928 American interests, headed by Bonbright & Co., Inc., and Field, Glore & Co., Inc., investment bankers, and Italian interests, headed by Banca Commerciale Italiana, an Italian commercial bank, organized Italian Superpower Corporation.[307] The capital assets were to be purchased by the investment company from those sponsors, principally from the Italian group, who were to receive payment ⅓ in preferred stock and ⅔ in cash to be raised by the sale to the American public of $20,250,000 of 35-year, 6% debentures.

All of the Class B voting common stock was to be divided equally between the American and the Italian groups, and the Class A nonvoting common stock was to be given as a bonus, half to the purchasers of the preferred shares and half to the purchasers of the debentures.[308] Although 303,750 shares of the block of Class A, nonvoting, common stock were delivered to the American sponsors for use in connection with the sale of the debentures, at the time of the public offering on January 31, 1928, market conditions had so improved that the American sponsors distributed only 101,250 Class A common shares with the debentures and gave ten-year option warrants to purchase 202,500 Class A common shares at prices ranging from $10 to $20 a share.[309] Each unit consisted of a $1,000 debenture, five shares of Class A, nonvoting common stock and an option war-

[302] Id., at 3042. In addition, the investment company paid approximately $133,000 for qualifying its stock in the desired states, for listing it upon the desired exchanges, and for organization expenses, including all issue and stamp taxes and the fees and disbursements of underwriter's counsel, as required by the terms of the underwriting agreement. (Reply to the Commission's questionnaire for Petroleum Corporation of America, Pts. I and V.)

[303] Op. cit. supra, note 300, at 2868–9.

[304] Id., at 2869.

[305] Id., at 2869–70.

[306] Reply to the Commission's questionnaire for Petroleum Corporation of America, Pt. V. The distribution of the shares of Petroleum Corporation of America is also of interest because of the substantial trading in the shares of the investment company which was resorted to in order to facilitate the sale of the issue. The syndicate apparently had to repurchase about 800,000 shares of the total of 3,250,000 shares which were originally sold, or roughly 25%. (Op. cit. supra, note 300, at 3044.) The public offering was in fact reduced by 220,600 shares sold at $31.25 to a selected list, largely affiliated with the sponsors (reply to Commission's questionnaire for Petroleum Corporation of America, Pt. V), and by 500,000 shares sold to Sinclair Oil Company, later known as Consolidated Oil Company. (Op. cit. supra, note 300, at 3045.)

[307] Reply to the Commission's questionnaire for Italian Superpower Corporation, Pt. I.

[308] Op. cit. supra, note 173, at 7660–4.

[309] Id., at 7662–3.

rant to purchase ten additional shares.[310] These option warrants differed from the usual option warrants in that they were not issued by the investment company but were issued by Bankers Trust Company as depository for the American sponsors. If the warrants were exercised, the proceeds would go to the American sponsors—if they expired unused, the shares were to be returned to these sponsors. Another 120,000 shares of the nonvoting Class A common stock were given with the sale of $6 cumulative preferred stock for $3,000,000 to interests affiliated with the sponsors.[311]

As a consequence the American sponsors received a seven-point underwriting spread upon the debentures and 22½% of the common stock, including half of the Class B common stock which possessed the entire voting power.[312] It was urged that the seven-point spread was to cover organization expenses and other costs in connection with the original formation of the company.[313]

After operating for slightly more than a year, Italian Superpower Corporation decided to raise an additional $2,000,000 for the investment company. The method used to raise these additional funds was to have the investment company repurchase $2,000,000 of its outstanding debentures and then sell through the bankers $4,000,000 of debentures, $2,000,000 of new bonds and the $2,000,000 of repurchased bonds.[314] The reasons for the adoption of this procedure of buying back $2,000,000 of its debentures for immediate resale were not made clear. From the data available concerning the operation of this repurchase and resale account the effect, if not the purpose, was to stabilize the market during the period of distribution of the $2,000,000 of the new bonds.[315]

The actual operation of the account was as follows: On July 5, 1929, Italian Superpower Corporation started to buy back its 6% debentures and by July 16 had purchased $556,000 face amount of debentures at an average price of $78½. Apparently during the same period Field, Glore & Co., Inc. and the Banca Commerciale Trust Company had also been buying debentures, presumably for the account of the investment company or with the understanding that the company would take over these debentures. In any case, on the 16th of July 1929, the investment company purchased from these two bankers a total of $897,000 face amount of debentures at an average price of $80, the highest price paid during the operation of the account. From July 5 to July 16, 1929, while these purchases were being made, the price of the debentures rose from 76 to 79. On July 18, 1929 the American bankers made an offering of $4,000,000 of debentures together with certain options described below. At the time of this offering Italian Superpower Corporation was prepared to issue $2,000,000 of new debentures, but had actually repurchased only a total of $1,469,000 of the outstanding debentures. Therefore, the sale of debentures represented a short

[310] Id., Commission's Exhibit No. 701.

[311] Op. cit. supra, note 307, Pt. V.

[312] Op. cit. supra, note 173, at 7670, 7705.

[313] Ibid. This spread may be compared with the underwriting commission of 5% upon a subsequent issue of the same debentures coupled with similar option warrants of Italian Superpower Corporation on July 18, 1929.

[314] Id., at 7695–6.

[315] Id., at 7700 and op. cit. supra, note 307, Pt. V.

position on the part of the investment company of $531,000 which was not completely covered until October 15, 1929.[316]

As a result, Italian Superpower Corporation repurchased $531,000 face amount of its debentures during the period when the bankers were distributing $4,000,000 of its debentures.[317] The short position in the debentures represented about 13% of the face amount of the offering and 16% of the amount actually sold by the investment company. The investment company's activities in repurchasing $2,000,000 of its own bonds in order to facilitate the raising of $2,000,000 of new money presumably saved the bankers from the necessity of operating an account to stabilize the market. Although the selling commission to the bankers on this financing was ostensibly only 5%, from the viewpoint of the net increase in assets realized by Italian Superpower Corporation from this operation the underwriting cost was in fact more than 10%.

When examined about the operation of a stabilization account by an investment company in connection with a distribution by bankers of an issue of its securities Sidney A. Mitchell testified:[318]

Q. So far as your experience with the American Superpower and the one or two other investment trusts you were interested in, and mainly utilities, do you know of any instance in which the corporation has maintained a stabilizing account?

A. I don't know, but the fact I don't know does not mean at all that they may not have done so.

National Investors Group

The successive financings occasioned by the formation of the companies comprising the National Investors group provided compensation for distribution in the form of option warrants for the shares of the parent company and increasing rates of selling commissions for each successive subsidiary company.

National Investors Corporation was organized on June 16, 1927, under the sponsorship of Fred Y. Presley, Guardian Detroit Company of Detroit, Mich., and Shawmut Corporation of Boston, Mass. Voting control was held by Guardian Detroit Company while Mr. Presley exercised complete operating control. Three investment companies, known as Second National Investors Corporation, Third National

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[316] Derived from supplementary information supplied the Commission for Italian Superpower Corporation.

[317] Ibid.

[318] Op. cit. supra, note 29, at 7702. Bonbright & Co., Inc., with which Mr. Mitchell had been connected, had floated several hundred millions of dollars of securities. (Id. at 7703.) Mr. Mitchell urged that Italian Superpower Corporation did not involve itself in any risk by reason of the short position which it had taken in its debentures at the time of public offering, for the investment company was repurchasing the debentures at 78 at a time when it had contracted to deliver them at 86. (Id., at 7697–8.) This calculation, however, ignored the fact that the debentures were all repurchased free of warrants or other securities and were sold in units with warrants entitling the holder to purchase 15 shares of Class A, nonvoting common stock for each $1,000 bond. (Ibid.) These warrants were similar to those which had been sold with the original $20,250,000 of debentures and the early warrants were then selling at between $8 and $12. (Id., at 7699.) Therefore, it may reasonably be assumed that the value of the warrants which were added to the debentures was 15 times about $10, or about 15 points on a hundred dollars face amount of debentures. Thus, at the time the investment company was repurchasing debentures at $78, it had contracted to deliver at $86 securities worth roughly 15 points more than 78.

Investors Corporation, and Fourth National Investors Corporation, were organized with varying capital structures as subsidiaries of National Investors Corporation and the combined paid-in capital of the group, eliminating cross holdings, was some $48,600,000.[319]

The shares of National Investors Corporation were sold privately by the sponsors in return for option warrants, the value of which was allegedly unknown at the time.[320] The benefits received by this parent company, through its position as a preferred buyer of the shares of the subsequent companies, as well as from the equity leverage thereby created and extended, naturally accrued in large measure to those sponsors through their option warrants.

The Guardian Detroit Company received the original option warrants for 100,000 shares of common stock of National Investors Corporation under an agreement contemplating a specified plan of redistribution of half of them to various of the other sponsors.[321]

In the subsequent history of National Investors Corporation, other parties began to participate in the distribution of the affiliated investment company securities and in the general sponsoring of the group. Some of the options originally distributed were repurchased by Guardian Detroit Company and reassigned in order to take care of these parties.[322] Reassignments of options occurred in connection with Paul Cabot, president of State Street Investment Corporation and, at that time, also affiliated with Shawmut Association. Shawmut Association had joined the National Investors group shortly before the original distribution of National Investors Corporation units, and had agreed to take up about $100,000 of such units and received 19,000 option warrants. Mr. Cabot, who was to join the National Investors Board of Directors at the request of Shawmut Association, refused to do so unless he were given 5,000 option warrants. Shawmut finally gave up 5,000 of its own option warrants to Mr. Cabot to effect this arrangement.[323] The instance of Mr. Cabot, as well as the general history of the issuance and redistribution of these warrants, indicates the value placed upon them by the insiders.

The market value of these option warrants increased very rapidly with advances in the market price of the common stock of National Investors Corporation. Between July 3, 1929, when this common stock was first traded on the New York Curb Exchange, and September 16, 1929, the price rose from 11¼ to 391¾. This advance in the price of the common stock, which substantially exceeded the net asset

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[319] For details of sponsorship and capital structures see supra, pp. 887 et seq.

[220] Public Examination, National Investors Corporation, at 4263, 4342.

[321] Id., Commission's Exhibit No. 417. Those warrants for 50,000 shares were subsequently reallocated as follows: 20,000 to Mr. Presley, 19,000 to Shawmut Association, 5,000 to George Murrane, a member of the firm of Lee Higginson & Co., 5,000 to S. Sloan Colt, a vice president of the Farmers Loan & Trust Company, and 1,000 to James S. Rattray, who had aided Mr. Presley in the sale of stock.

The basis for determining this reallocation is illustrated by the case of Mr. Colt, at that time vice president of the Farmers Loan & Trust Company. Mr. Presley testified that the prestige of the man's name, as well as the name of the organization with which he was associated, was useful to National Investors Corporation. (Id., at 4337.) For instance, Mr. Colt was instrumental in securing additional bank outlets for the group. (Id., at 4268–9.)

[322] Among these parties were Marine Trust Company, Brown Brothers & Company, N. W. Harris & Company, and the law firm of Cotton and Franklin. (Id., at 4382–5.)

[323] Op. cit. supra, note 320, at 4383 and Public Examination, State Street Investment Corporation, at 2758–61.

value of the common stock,[324] may be attributed not only to the general advances in market prices and premiums which such shares then enjoyed, but also to trading activities under the auspices of Guardian Detroit Company, facilitated by the relatively small number of such shares available for trading.[325]

Control over the reallocated option warrants was retained by Guardian Detroit Company through specific agreements with the recipients, limiting the sale or exercise thereof.[326] Sales of these warrants by the individual holders were customarily made to Guardian Detroit Company for the purposes of redistribution, as aforesaid, or as a part of its market sponsorship program,[327] at prices substantially below the values indicated by market quotations. However, these market quotations must have induced the payment of the substantial sums realized for the warrants sold by the sponsors—warrants which cost them nothing. S. Sloan Colt sold 4,500 of the 5,000 option warrants allotted to him by reason of his connection with Farmers Loan and Trust Company, for a total of $285,000.[328] Mr. Murane, of Lee, Higginson & Co., sold 3,500 of his 5,000 option warrants for a total of $414,850.[329] Mr. Presley testified:[330]

Q. Would his services have been worth that in cash?

A. Certainly at that time we would have never contemplated that would have been worth that in cash.

Q. Well, would you today consider they were worth that in cash?

A. No; not at all.

Similarly, Mr. Cabot sold 3,500 of his 5,000 option warrants for $355,000 and Mr. Presley sold 3,000 of his 20,000 option warrants for $300,000.[331]

In the underwriting agreement, National Investors Corporation agreed to use its best efforts to secure underwriting business from its

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[324] Basing the net assets of National Investors Corporation on the market values of its investments, including investments in common stocks of its subsidiary investment companies, investments in the warrants of Second and Third National Investors Corporation valued at the difference between the market value of the stock and the exercise prices, investments in the warrants of Fourth National Investors Corporation valued at the sales price of $12.50 a share, and assuming the exercise of warrants for 104,369 shares at $10 a share, the net asset value of the common stock of National Investors on September 16, 1929, equaled $91.09. Basing the net assets upon the market values of the miscellaneous investments of National Investors Corporation and upon the market values of the underlying assets of the affiliated investment companies, the preferred stock of National Investors Corporation possessed an asset value of only $89.60 on that date and the common stock consequently had a negative asset value. (Op. cit. supra, note 320, at 4350–1.)

[325] The rapid advance in the market price of the common stock of National Investors Corporation caused an investigation by the New York Curb Exchange and on August 15 and September 13, 1929, Mr. Presley assured the exchange that Guardian Detroit Company would maintain an orderly market. (Op. cit. supra, note 320, at 4357–8.) An analysis of the purchases and sales made under the auspices of Guardian Detroit Company during the period July 3 to September 12, 1929, when a total of 10,800 shares were sold while only 5,420 shares were bought in 100 share lots, indicates that sales were made at times when the market exhibited considerable trading strength and that purchases were so timed that they must have assisted in raising the price from 11¼ to 155. (Derived from supplementary information supplied the Commission for National Investors Corporation.)

[326] Op. cit. supra, note 320, Commission's Exhibit No. 417, and Public Examination, State Street Investment Corporation, Commission's Exhibit No. 310.

[327] Op. cit. supra, note 320, at 4282–5, 4338–42.

[328] Id., at 4338.

[329] Id., at 4340.

[330] Id., at 4341.

[331] Id., at 4342–3.

investment company subsidiaries for Guardian Detroit Company[332] and increasing remuneration was provided to those underwriters for the issues of each new investment company. The gross commission on the shares of Second National Investors Corporation was 4% of the public offering price, 6% on the shares of Third National Investors Corporation, and 7.7% on the shares of Fourth National Investors Corporation.[333] Mr. Presley testified:[334]

Q. What was the justification for this fee amounting to 6.4% of the net proceeds to the corporation, in view of those market conditions?

A. In the first place, the fee of 4% in the Second was probably too small, in view of existing circumstances, and it was nothing more nor less than a straight promotion, investment trust, to be managed by an absolutely untried and unknown management.

Even when Fourth was formed, the management was untried, and it was semi-promotional, and I don't believe that the underwriters realized that they were going to have as easy a time selling that $27,000,000 as they did.

Q. Still, it was an anticipation of an easy time in selling that, that made you optimistic enough to have an all-common stock picture, which would be offered at a total of $26,000,000 to the public. You had never attempted a thing of that size prior to that time, had you?

A. I pushed the underwriters pretty hard to underwrite that issue, and I remember that distinctly, and just before the issue was brought out, I think that they were extremely worried about their commitment.

Q. But if it is a fact that it was the best judgment of the underwriters that this market could absorb $26,000,000 worth of common stock in this new company, which was now to be the fourth of these companies, it would seem that they wouldn't have anticipated any great difficulty in placing the stock, otherwise they wouldn't have made a commitment to underwrite $26,000,000 worth.

A. The fact of the matter is that they wouldn't have committed without that underwriting fee.

The close relationship between the investment companies and their sponsors outlawed competitive bidding for the underwriting business even after two years of operation. Mr. Presley testified:[335]

Q. Did you attempt to place the issue elsewhere?

A. No; I didn't.

Q. Now, Guardian Detroit had preferential right to future financing of these companies, under the terms of its contract.

A. Yes.

Q. That took the usual form?

A. Yes.

Q. They made the future financing on at least the same bases as anybody else would take it, that is to be given prior right on the same terms.

A. Yes.

Q. Did you attempt to get better terms from any other underwriter?

A. We attempted to get better terms from the existing underwriters, and I know there was quite a lot of controversy over the fact that there was an increase in the commissions paid the underwriters, but I don't recall seeking or negotiating with outsiders.

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[332] Id., Commission's Exhibit No. 418.
[333] Op. cit. supra, note 84, Pt. V.
[334] Id., at 4313–14.
[335] Id., at 4314–15.

Q. Did it occur to you to do that, or did you realize that that might have been undesirable from your standpoint at that time?

A. Well, I just accepted the fact that no other group of underwriters would have considered floating a big trust, such as that.

F. Sales to Preferred or Selected Lists

Sales to preferred lists or selected persons were in effect forms of private distributions at prices more favorable than offered to the public in general. This special treatment usually took the form of a reduction or total waiver of the sales commission. In some instances discounts were even greater and constituted in effect a dilution of the equity of the public participation.[336] Similarly, special terms, in the form of credits or options, were sometimes afforded to such favored purchasers.

As has been indicated, about half of the 1,000,000 share issue of capital stock offered by The Goldman Sachs Trading Corporation was sold to a preferred list of investors (including Goldman Sachs & Co., the investment banker sponsor, members, and clients of that firm, their families, and associates) who were included in the selling group.[337] As such participants they paid only the selling group price of $102 a share as contrasted with the public offering price of $104 a share. At least 343,000 of these shares were sold to selling group purchasers who were not dealers in securities but who were largely banking clients and associates of Goldman Sachs & Co.

Similarly, Blair & Co., Inc., which underwrote the original block of 650,000 shares of Petroleum Corporation of America to net that investment company $31 a share, sold 220,600 shares thereof to a preferred list of 58 individuals at $31.25 a share, or $2.75 below the public offering price.[338]

Although a delay of several months elapsed between the private distribution and public offering of the shares of United States & Overseas Corporation, the effect was to give the sponsors a substantially preferred position in the purchase of its securities at the expense of the public investors.[339] This investment company was formed on January 23, 1929, at which time it issued 200,000 shares of its capital stock to its sponsors at $10 a share for a total of $2,000,000.[340] Between April

[336] An instance of such practices was provided by Shawmut Association, organized in May 1928 by the National Shawmut Bank of Boston and its security affiliate, Shawmut Corporation. Rights to purchase 300,000 shares of the investment trust at $50 a share were offered to the stockholders of the National Shawmut Bank while an additional 20,000 shares were offered to the management of the bank at $51.50 a share. At the same time there was a public offering of 80,000 shares at $52.50 a share, including a $1 loading charge, making a total paid-in capital of $8,150,000. In view of the substantial block sold to the stockholders of the bank at $50 a share, $1.50 a share less than was realized from the sales to the management and to the public, a substantial dilution of their equities was immediately suffered. (For further details see supra, pp. 915 et seq.)

[337] For further details see supra, pp. 922 et seq.

[338] This group included 41 prominent persons who became directors of the investment company while the remaining persons were officers or directors of Blair & Co., Inc. (For further details see Ch. II of this part of the report, pp. 227–309.)

[339] The technique of distribution employed by United States & Overseas Corporation was similar to that employed by General Investment Corporation. (For further details see Ch. II of this part of the report, pp. 518–27.)

[340] Op. cit. supra, note 234.

and June 1929 the sponsors subscribed to another 400,000 shares at the same price, providing additional paid-in capital of $4,000,000.[341]

In contemplation of a public offering a syndicate composed of the then sponsors was formed and acquired 450,000 shares from the investment company at $36 a share, adding $16,200,000 to the capital to total $22,200,000. This syndicate also acquired from the original sponsors at $20 a share 150,000 shares of their holdings, thereby providing a 100% profit upon an investment held for less than a year.[342] After a reclassification of the capital structure into 750,000 shares of common stock, including the 600,000 shares held by the syndicate and 300,000 shares of Class A stock,[343] the public offering was made at $35 a share.[344]

Thus the public contributed $35 a common share and the original subscribers contributed $10 a common share to receive an investment having a paid-in value of $25.60 a share, attributing only $10 a share to the Class A stock held by the sponsors. In other words, the public paid $21,000,000 for an interest of $15,360,000 upon a paid-in basis, while the sponsors paid $4,500,000 for a $6,840,000 participation, exclusive of the $1,500,000 profit realized upon the sale of 150,000 shares to the syndicate.[345]

G. Relieving Insiders From Commitments for Security Issues

The market collapse at the end of 1929 had the effect of transforming seemingly profitable commitments for the purchase of the security issues of investment trusts and investment companies into burdensome obligations. While the ordinary subscribers could not usually secure releases from their obligations, insiders sometimes received more generous treatment.[346]

Ungerleider Financial Corporation

Ungerleider Financial Corporation was incorporated on May 7, 1929,[347] at the instance of Samuel Ungerleider & Company, members of the New York Stock Exchange and investment bankers. On May 8, 1929, Samuel Ungerleider & Company entered into an agreement with the investment company to purchase 500,000 shares of its com-

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[341] Id., Commission's Exhibits Nos. 3960, 3961.

[342] Id., Commission's Exhibits Nos. 3960, 3964, and 3980.

[343] The common stock and the Class A stock were identical except that the common stock had a priority upon liquidation to the amount paid in therefor of $25.60 a share and the Class A possessed 33⅓% of the combined voting power of the two classes and the right to its paid-in investment upon liquidation before a general distribution of assets. (Id., Commission's Exhibits Nos. 3959, 3960.)

[344] Op. cit. supra, note 234, Commission's Exhibit No. 3980. The underwriting spread was $3 a share or $1,800,000. (Id., at 2535.)

[345] For a discussion of a selected list in marketing the shares of The United Corporation see Report of the Senate Committee on Banking and Currency on Stock Exchange Practices, 73d Cong., Senate Report No. 1455 (1934), at 103 et seq.

[346] See supra, pp. —. For other examples of releases from commitments see Vick Financial Corporation, Selected Industries, Inc., and Chatham Phenix Allied Corporation, supra, pp. 893, 912, and 882, respectively.

[347] Op. cit. supra, note 37, Commission's Exhibit No. 1528. It was the intention of Samuel Ungerleider & Company that the investment company would engage primarily in the underwriting and distribution of securities, activities which had been previously engaged in by Samuel Ungerleider & Company only to a limited degree. (Id., at 14879–80.)

mon stock at $50 a share or for a total of $25,000,000.[348] The agreement provided, however, that if in the opinion of Samuel Ungerleider & Company market conditions were unfavorable for the public sale of the stock, Samuel Ungerleider & Company could terminate the agreement as to 450,000 shares of the stock. In any event, Samuel Ungerleider & Company was firmly committed to purchase 50,000 shares of the investment company for $2,500,000.

Samuel Ungerleider & Company entered into an agreement with a selling group to offer the 500,000 shares to the public at $52 a share.[349] This agreement provided that shares sold by members of the selling group which were resold by investors on the market and repurchased by Samuel Ungerleider & Company could be "put back" to the selling group members for resale.

On May 13, 1929, Samuel Ungerleider & Company and the investment company entered into an agreement modifying the agreement of May 8, 1929, whereby Samuel Ungerleider & Company undertook to use its "best efforts" to market 400,000 shares.[350] In consideration of this modification Samuel Ungerleider & Company agreed to purchase in any event 100,000 shares of the stock. The agreement, which was not disclosed to stockholders, also provided that if Samuel Ungerleider & Company could succeed in firmly placing with investors at least 250,000 shares of its stock, the investment company would "cooperate with the selling group" by repurchasing its own shares through Samuel Ungerleider & Company at prices not to exceed $50 per share. In effect the investment company was committed to maintain and stabilize the market price of its own shares at or about the offering price of the shares to the public in order to enable the selling group to dispose of the shares to the public.

Mr. Ungerleider stated that the reason for the change in the underwriting arrangement was to guarantee more capital to the investment company by increasing the firm commitment of the sponsor.[351] When examined on the statement in the offering circular that the sponsor, Samuel Ungerleider & Company, was purchasing 100,000 shares at $50 per share Mr. Ungerleider testified:[352]

A. We started on the premise that we wanted the corporation to have not less than $5,000,000 and we would assume the responsibility of either putting in $5,000,000 or selling it sufficiently.

Q. But ordinarily, at this time, when there was a statement made in the offering circular, that the sponsors were buying a block of stock, everybody assumed that that was a permanent investment that the sponsor was making in the investment trust, isn't that so?

A. You may assume that.

Q. The fact of the matter is that Ungerleider & Company did not hold the 100,000 shares, isn't that so?

A. That is right.

Q. Your maximum permanent investment in Samuel Ungerleider Corporation was how much?

A. Twenty some thousand shares.

[348] Op. cit. supra, note 37, Commission's Exhibit No. 1530.

[349] Id., Commission's Exhibit No. 1533. Of the $2 gross commission per share, 50 cents accrued to Samuel Ungerleider & Company as its banking commission and $1.50 was allocated to the dealers as their commissions.

[350] Op. cit. supra, note 37, Commission's Exhibit No. 1531.

[351] Id., at 14886.

[352] Id., at 14984–6.

Under the terms of this contract the total block of 500,000 shares of stock was delivered to the sponsor-underwriter by the investment company.[353] At December 11, 1929, when the public offering was terminated, the sponsors had succeeded in disposing of 435,978 shares, netting the investment company $21,798,900.[354]

However, the investment company repurchased through Samuel Ungerleider & Company a total of 222,359 shares of its own stock at an average price of $49 per share for a total of $10,992.858.16 in accordance with the above agreement.[355] On these repurchases and resales to the investment company, the firm of Samuel Ungerleider & Company suffered a loss of $281,160.17, having purchased the shares at that sum in excess of the price at which the shares were sold to the investment company.[356] Of the repurchased shares 72,549 shares were "put back" to the selling group at $50 per share for a total of $3,627,450.[357] Other selling group dealers refused to accept the remaining 149,810 shares.[358] No attempt was made to enforce the obligation of the members of the selling group who defaulted. Apparently the sponsor did not desire to jeopardize the good will of such dealers who might be essential to the possible future underwriting activities of the investment company and to the business of the sponsor.[359] The 149 810 shares repurchased by the investment company at a cost of $7,365,-408.16 were retired by the investment company pursuant to the vote of a majority of a quorum of its stockholders.[360] The attitude of the sponsors of Ungerleider Financial Corporation making these repurchases was discussed in the following testimony of Mr. Ungerleider: [361]

Q. Now, it is true that Ungerleider took the loss, but is there not a fundamental principle which transcends the loss that Ungerleider took? Here is the situation where a corporation within a short period of time after it was organized, and supposed to be a $25,000,000 company finds itself in a position where it has got to go out and buy back a block, approximately half of its original issue; isn't that so?

A. That is what happened.

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Q. And that was all occasioned by the fact that you didn't want to lose the good will of the dealers; isn't that right?

A. Yes, sir.

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[353] As money was received by the sponsor-underwriters from the members of the selling group, it was deposited in the general account of Samuel Ungerleider & Company instead of being held in trust or earmarked for the account of the investment company. (Id., at 14895–7.)

[354] Op. cit. supra, note 37, at 14897.

[355] Id., at 14909. The problem is presented whether, in effecting these repurchases in connection with which the investment company utilized about $6,000,000 of its capital (id. at 14987–9), the provision of the Delaware corporation law forbidding repurchases of its own shares with capital funds was not contravened. (General Corporation Law of Delaware, Revised Code of 1915, as amended, Ch. 65, Art. 1, Sec. 19). On May 8, 1929, the directors of the investment company by resolution allocated $40 of the $50 received from the sale of each share of stock to capital, and the balance to paid in surplus. (Op. cit. supra, note 337, at 14987.)

[356] Op. cit. supra, note 37, at 14996.

[357] Id., at 14909.

[358] Id., at 14898.

[359] Id., at 14899.

[360] Id., at 14909.

[361] Id., at 14996–7.

Q. There is another aspect to that, Mr. Ungerleider; after all, your name was in this corporation; wasn't that so?

A. Yes, sir.

Q. And whether you liked it or not, people would associate the success of the investment trust with your ability; isn't that so?

A. To some extent that is correct.

Q. That was a matter of concern to you all of the time; wasn't that so?

A. Yes, sir.

The stockholders also authorized the investment company to repurchase an additional 36,168 shares of its stock in order to bring the outstanding shares of the corporation down from a total of 286,168 shares to an even 250,000 shares. Actually, the investment company repurchased an additional 41,768 shares, leaving finally outstanding 244,400 shares of its stock for which the investment company had received a total consideration of $13,205,575.76.[362]

The prospectus indicated that the purchasers of the stock were to become stockholders in a $25,000,000 corporation, and a memorandum dated October 18, 1929, written by M. J. Hall, an employee of the investment company, to Samuel Ungerleider, its president, stated:[363]

> Our purpose in withholding the release of the balance sheet, portfolio, income account, listing application, and advertising campaign was to permit of a "put back" and redistribution program that would permit of the release of a balance sheet showing a total of 500,000 shares actually outstanding.

The stockholders were never apprised that the failure of the distribution campaign was the real reason for this reduction in capitalization.[364]

Federated Capital Corporation

Similarly, the sponsors of Federated Capital Corporation were released from taking up the unfulfilled balance of a commitment for common shares of that investment company when the market started to decline.

Federated Capital Corporation was organized on April 7, 1927, under the laws of Delaware by William J. Thorold, formerly associated with investment companies in England.[365] On April 22, 1927 Federated Capital Corporation entered into an agreement with Federal Debenture Company, Inc., controlled by Mr. Thorold, providing for the purchase by Federal Debenture Company, Inc., of 9,600 shares of the investment company's 6% cumulative preferred stock possessing one vote a share, and 6,000 shares of its common stock, also possessing one vote a share, for a total consideration of $360,000.[366] In return for this commitment upon the part of Federal Debenture Company, Inc., Federated Capital Corporation granted to Federal Debenture Company, Inc. an exclusive sales agency until July 1933 to sell the remainder of its authorized preferred and common stock to provide a total capital of $10,000,000. Federal Debenture Company, Inc. was to pay $25 for each share of preferred stock and $20 for each share of the common stock of Federated Capital Corporation less

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[362] Id., at 14909–10.

[363] Id., Commission's Exhibit No. 1536.

[364] Id., at 14914–16.

[365] See supra, pp. 896–7.

[366] Op. cit. supra, note 33, Commission's Exhibit No. 1472.

a total selling commission of 10% of the purchase price. Of this 10% selling commission Federal Debenture Company was to retain 1%, and 9% was to be paid to dealers employed by Federal Debenture Company to actually sell the securities.

The contract did not fix the price at which the securities were to be offered to the public. Actually, however, the common stock was distributed to the public at market prices which from 1927 to 1929 were considerably in excess of $20 per share, but remittances were made to Federated Capital Corporation of the $20 selling price of the common stock less 10% sales commission.[367] On February 25, 1929, this exclusive agency was canceled and a new one entered into with Federated Management Corporation, a successor company also controlled by Mr. Thorold.[368] This new contract was similar in its provisions to the former contract except that the price to be paid by Federated Management Corporation to Federated Capital Corporation for its common stock were fixed at asset value plus 15% of such asset value.

Neither Federal Debenture Company, Inc., nor Federated Management Corporation actually sold the securities of Federated Capital Corporation to the public. Instead a contract[369] was entered into by these companies for the distribution of the securities by P. H. Whiting & Co., Inc., in return for a commission of 9% of the selling price of the shares to the public while a 1% commission was retained by the Thorold-controlled companies. This commission, Mr. Thorold testified, was paid to his companies, primarily for their assistance in preparing the issues and drawing the prospectuses.[370]

During this same period, on January 18, 1929, Federated Debenture Company, Inc. and P. H. Whiting & Company, Inc. each agreed to take down 12,500 shares of the common stock of Federated Capital Corporation (a total of 25,000 shares) at $50 a share.[371] Approximately 16,000 shares were taken down under the terms of the agreement in the months following.[372] During the same period the market price of the stock steadily advanced, reaching a high of $80 a share in October 1929.[373] These underwriters shared the profits thereby occasioned but after the market decline they were faced with the prospect of taking down the balance of their commitment at a loss.[374] However, Federated Capital Corporation was caused to release its sponsors from their further obligations under the contract.[375] Mr. Thorold testified in this connection as follows:[376]

Q. Well, the situation was that in a rising market you took down the 16,000 shares and there was a release given to you. Was there any discussion or any offer or gesture on your part saying, "Well, this may be a mistake. I am being relieved of a $450,000 obligation. I have to take down stock at $50 and the market is as low as $18. I think maybe I ought to account for the profits I made on this situation."

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[367] Id., at 14495–9.
[368] Id., at 14425–7 and Commission's Exhibit No. 1495
[369] Id., Commission's Exhibit No. 1473.
[370] Id., at 14457.
[371] Id., Commission's Exhibit No. 1480.
[372] Id., at 14501–2.
[373] Id., at 14504.
[374] Id., at 14502–3.
[375] Id., at 14503–12.
[376] Id., at 14511–12.

A. No, it was regarded as an emergency measure.

Q. An emergency measure where you stood to lose?

A. No, an emergency measure having regard to all the facts. The facts were we had a large number of brokers committed and our commitment was taken on the basis that they would fulfill their commitment.

Q. You don't testify that when you made this firm commitment in writing in a letter that was a couple of pages long——

A. No, it was not part of the written undertaking, but the general understanding was we were to fulfill commitments from brokers. We were not taking a speculation on our own part.

Q. I am convinced of that. You were playing it sure, because while the market was going up, you took it, and when the market crashed, you asked for an extension and got a release.

A. Well, you have scored on me there.

The stock of Federated Capital Corporation was continuously offered to the public from 1927 to May of 1931 when Atlas Corporation acquired control of the company. A total of 122,320 shares of the cumulative preferred stock and 218,399 shares of the common stock were sold to the public by P. H. Whiting & Company, Inc., and its subdealers.[377] On these sales the corporation received a total of $6,122,680.37.[378] The total selling commissions were $310,291.52 of which 10% or $31,029 was retained by Mr. Thorold's companies, Federal Debenture Company, Inc. and Federated Management Corporation, and the remainder was retained by P. H. Whiting & Company, Inc., and its subdealers.[379] This was, of course, exclusive of the trading profits made possible under the agreement of January 18, 1929, previously referred to.[380]

H. Liquidation of Sponsor's Initial Investments in Investment Companies

The sponsors of some investment trusts and investment companies made substantial investments in their investment companies at the times of organization—a fact which was invariably emphasized in the offering circulars. However, in some instances these investments were not of long duration. The sponsors, either during the distribution period or almost immediately thereafter, reduced or liquidated their holding at high prices and still retained control of the investment companies.

By the operation of a series of trading accounts in both the publicly offered and privately offered securities, the banker-sponsors of

[377] Charles H. Gleason, vice president of P. H. Whiting & Company, Inc., testified that Federated Capital Corporation stock was virtually sold from door to door in small amounts by 125 subdealers in small localities (Id., at 14570–1). Few shares of the stock were sold in New York City (Ibid.).

[378] Op. cit. supra, note 33. Commission's Exhibit No. 1476. By May of 1931, the net assets of the investment company had depreciated to $2,845,000 (Id., Commission's Exhibit No. 1958).

[379] Op. cit. supra, note 33, Commission's Exhibits Nos. 1472, 1476, 1495.

[380] In connection with and to facilitate the primary distribution of the stock, P. H. Whiting & Company, Inc., maintained an over-the-counter market for the company's securities and continued to do so as long as the shares were being offered (Id., at 14563–4). Federated Management Corporation also engaged in market-supporting operations in Federated Capital Corporation's stock, particularly after the market collapse of October 1929 (Id., at 14592).

Selected Industries, Inc. were enabled to complete the public offering as well as to liquidate the major portion of their holdings.[381]

United States & Foreign Securities Corporation

Similarly, the sponsor of United States & Foreign Securities Corporation caused Dominick & Dominick, investment bankers, to operate a trading account in the investment company's shares which enabled the sponsor to liquidate its holdings (in part to its customers) at substantial profits and without relinquishing control of the investment company.

United States & Foreign Securities Corporation was formed on October 9, 1924, under the sponsorship of Dillon, Read & Co., investment bankers.[382] A public offering was made of 250,000 units consisting of one share of first preferred stock and one share of common stock, for a total of $25,000,000. Allotment certificates were offered by Dillon, Read & Co. and associates upon a part-paid basis of 25% in cash with the balance subject to call. The underwriters received at once a gross commission of 4% of the selling price of the entire offering of $25,000,000 or $1,000,000 from the original paid-in subscription of $6,250,000. By the terms of the underwriting agreement the investment company also agreed to invest some $5,000,000 of its assets in certain designated securities.[383] In November 1927, after the fourth payment on the allotment certificates became due,[384] the 250,000 shares of common stock sold to the public became available for trading and on February 9, 1929, these shares were listed upon the New York Curb Exchange.

In addition, the investment company, as part of the original distribution of its capital stock, sold 50,000 shares of second preferred stock, together with 750,000 shares of common stock, to Dillon, Read & Co. for $5,100,000.[385] While it might appear that an underwriting commission of only 4% of the offering price was paid, the sponsors received 16% of the amount paid in on the original subscription ($1,000,000 of the $6,250,000 so paid) plus three-fourths of the common stock at a nominal price, and a commitment by the investment company as to the investment of $5,000,000 of its assets (an amount approximately equal to the amount of capital stock subscribed for by Dillon, Read & Co.). The 750,000 shares of common stock which were sold to Dillon, Read & Co. were distributed among the directors and members of the firm of Dillon, Read & Co.[386]

Although the common stock and the second preferred stock acquired by Dillon, Read & Co. were sold to that firm in one block, the contracts indicated an allocation of $5,000,000 for a block of 50,000 shares of second preferred stock and 250,000 shares of common stock and $100,000 for a block of 500,000 shares of common stock.[387]

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[381] For further details see supra, pp. 912 et seq.

[382] Reply to the Commission's questionnaire for United States & Foreign Securities Corporation, Pt. I.

[383] Ibid.

[384] Derived from supplementary information supplied the Commission for United States & Foreign Securities Corporation.

[385] Op. cit. supra, note 117, at 11721.

[386] Id., Commission's Exhibit No. 1161.

[387] Hearings before the Senate Committee on Banking and Currency, pursuant to S. Res. 84, 72d Congress, and S. Res. 56 and S. Res. 97, 73d Congress, Pt. 4, pp. 1641–2.

Up to the end of 1928 there appeared to be no substantial activity in the shares sold to the sponsor, although there were some redistributions among the members and associates of the firm of Dillon, Read & Co. at $10 a share.[388] In the fall of 1928, Dominick & Dominick, members of the New York Stock Exchange, approached Dillon, Read & Co. with the suggestion that they be given options on some of the common stock held by that sponsor for the purpose of a secondary distribution of that stock.[389] This suggestion was rejected, but after negotiations an arrangement was made whereby some of the individual associates of the firm agreed to grant options to Dominick & Dominick on a total of 30,000 shares, later raised to 40,000 shares, at prices ranging from $47.50 to $55.[390] The market price when the options were granted was $54 a share.[391] Dominick & Dominick claimed that it wanted to be able to sell stock of the investment company to its clients, since that firm was convinced that the shares were under-valued in the market.[392] The plan was to sell the shares at the market price, thereby making a profit for Dominick & Dominick over the option price, and providing its customers with a security which it was willing to recommend.[393] The small floating supply of the shares presented an opportunity to enhance the margin of profit through market operations. Dillon, Read & Co. agreed to use its best efforts to prevent its holdings from coming into the market during the life of the options.[394] Once these market operations commenced Dominick & Dominick apparently chose to distribute by means of sales upon the exchange rather than by sales to their customers.

Two trading accounts were operated by Dominick & Dominick in this stock. The first, which commenced on December 20, 1928, took down 25,000 shares under the options, bought and sold a total of 129,650 shares, compared with a total reported volume in that stock on the New York Curb Exchange of 145,800 shares.[395] In other words, Dominick & Dominick actually bought or sold about 45% of all stock traded during the period.

The second account was formed to take over the unexercised options of the first account, together with options upon additional shares.[396] Dillon, Read & Co. took a 25% participation in this second account.[397] On July 5, 1929, or approximately two weeks after the account was formed (June 22, 1929), the stock was listed upon the New York Stock Exchange. The second account took down 49,198 shares against the options, the two accounts thus disposing of 74,198 shares at an average price of $53.18 a share.[398]

At the time that these accounts were operating, the same group of members and associates of Dillon, Read & Co. also made some of their holdings of the common stock available for distribution to the

[388] Id., at 1671, 1685.
[389] Id., at 1642–5.
[390] Ibid.
[391] Id., at 1654.
[392] Id., at 1642–5.
[393] Ibid.
[394] Id., at 1646–7.
[395] Id., at 1667.
[396] Id., at 1671.
[397] Ibid.
[398] Id., at 1641, 1685.

clients of that firm.[399] The reason for this willingness to sell stock which had been held almost without change for the preceding four years was attributed to the demand on the part of the customers of Dillon, Read & Co. to participate in the common stock of this company. That this demand was probably increased by activity created in the market by the transactions of the Dominick & Dominick trading account was admitted by Robert E. Christie, a member of the firm of Dillon, Read & Co.[400]

Dillon, Read & Co. sold for its members and associates 46,354 shares of the common stock of United States & Foreign Securities Corporation as well as an additional 11,000 shares which were withdrawn from the options given to Dominick & Dominick.[401] As a result Dillon, Read & Co. and associates disposed of a total of 120,552 shares of common stock for proceeds of $6,843,381.[402] If it be assumed that this stock originally cost 20¢ a share (the stated original cost of $100,000 for 500,000 shares), then the profit may be calculated to have been about $6,820,000. However, without attempting to calculate the original cost of the common stock, it is clear that Dillon, Read & Co., its members and associates, received $6,843,381 for a small portion of what had originally cost that firm $5,100,000 so that they had a profit of $1,743,000 by disposing of 17½% of their common stock holdings and, in addition, retained the entire issue of second preferred stock at no cost.

American, British & Continental Corporation

A secondary distribution program of a part of their holdings of American, British & Continental Corporation was conducted by its sponsors.

American, British & Continental Corporation was organized November 18, 1926,[403] under the joint sponsorship of the investment banking and brokerage houses of Blyth, Witter & Co. (now Blyth & Co., Inc.) and J. Henry Schroder Banking Corporation, in association with ten European banking houses.[404] This investment company began operations with subscribed capital stock consisting of 100,000 shares of $6 cumulative first preferred stock, 40,000 shares of $6 cumulative second preferred stock, and 400,000 shares of common stock for which it ultimately received $13,600,000.[405] The American bankers distributed the stock in a manner calculated to make the

[399] Id., at 1686.

[400] Id., at 1692–3.

[401] Id., at 1691–5.

[402] Id., at 1686.

[403] Public Examination, American, British & Continental Corporation, Commission's Exhibit No. 444.

[404] Id., at 4596, 4606, and Commission's Exhibit No. 450. The European banking institutions were Allgemeine Oesterreichische Boden Credit Anstalt, Austria; Societe Generale Belgique, Belgium; Bohemian Union Bank, Czechoslovakia; Banque de L'Union Parisienne, France; Dresdner Bank, Germany; J. Henry Schroder & Co., Great Britain; Hungarian Commercial Bank of Pest, Hungary; Lippman, Rosenthal & Co., Netherlands; Stockholm Enskilda Bank, Sweden; and Credit Suisse, Switzerland (Id., Commission's Exhibit No. 450).

[405] Op. cit. supra, note 403, at 4604–10, 4613, and Commission's Exhibit No. 444. The common stock possessed the exclusive voting power except after defaults in the payment of dividends upon the first preferred stock (Id., at 4010–11 and Commission's Exhibit No. 444).

investing public put up the bulk of the capital and to retain voting control for themselves and their European associates.

On November 18, 1926, American, British & Continental Corporation entered into a contract with Blyth, Witter & Co. and J. Henry Schroder Banking Corporation pursuant to which they agreed to offer to the public, at $100 per certificate, 100,000 allotment certificates, each of which represented one share of first preferred stock and one share of common stock.[406] The public subscribed to the entire issue for a total of $10,000,000, 50% payable in cash and the balance subject to call in two equal installments upon which the distributors were paid a commission of $400,000, equivalent to 4% of the total subscribed or 8% of the initial payment. Voting rights attached to these certificates to the extent that the sums paid in were equivalent to full-paid shares while the conversion of the certificates into shares could not be accomplished until a year later, on December 1, 1927. Calls were made for the unpaid balances due under these certificates on September 1, 1928, and December 1, 1928, and the entire offering became fully paid thereafter.[407]

The American sponsors and their European associates subscribed to 40,000 shares of the second preferred and 300,000 shares of the common stock of American, British & Continental Corporation in units of one share of second preferred and seven and one-half shares of common stock, at $100 per unit, for a total of $4,000,000.[408] One-half of this issue was taken by the American sponsors and affiliated companies, and the balance by the European banking houses.[409] The $4,000,000 investment was paid into the investment company without deduction for underwriting fees.[410] These sponsors, by their investment of $4,000.000, contributed 29.4% of the total capital of American, British & Continental Corporation. However, in purchasing 300,000 shares of common stock with the second preferred stock, they acquired 75% of the voting power of the company.

In February 1928, little more than a year after American, British & Continental Corporation began operations, it raised additional funds through the issuance of debentures, allegedly in order to reduce its indebtedness to the banks.[411] American, British & Continental Corporation issued $5,000,000 of 5% gold debentures to Blyth, Witter & Company and J. Henry Schroder Banking Corporation at 92, and then in turn offered them to the public at 96.[412] Thus, on February 23, 1928, the investment company realized an additional $4,600,000 capital. Added to the $13,600,000 netted on the sale of its preferred and common stocks, American, British & Continental Corporation raised a total capital of $18,200,000.[413] Of this sum, the bankers

[406] Op. cit. supra, note 403. Commission's Exhibit No. 446. The offering agreement was merely an agency agreement under which the sponsors assumed none of the risks of the offering or of the unpaid balances (Ibid.).

[407] Op. cit. supra, note 403, at 4612, and Commission's Exhibit No. 441.

[408] Id., at 4609.

[409] Id., Commission's Exhibit No. 446. The subscribers further agreed not to dispose of their holdings of second preferred or common stock without first offering such stock to the other subscribers (Ibid.). The common stock was immediately deposited in a voting trust and the directors of the investment company, all of whom represented the bankers, were voting trustees (Id., Commission's Exhibit No. 448).

[410] Op. cit. supra, note 403, at 4609–11.

[411] Id., Commission's Exhibit No. 450.

[412] Id., at 4626, and Commission's Exhibits Nos. 450, 451.

[413] Id., at 4633.

had put up $4,000,000, or 21.9% of the total capital, and at the same time obtained 75% of the voting power of the investment company.

After the public had invested over $14,000,000 in American, British & Continental Corporation, the bankers proceeded to recapitalize the corporation so as to reduce their own investment without relinquishing their position of control. At the same time a further public distribution of securities was made. On October 26, 1928, the directors of American, British & Continental Corporation, all of whom represented the American and European bankers, approved a plan of recapitalization and recommended its adoption by the stockholders.[414] The plan provided that the 40,000 shares of second preferred stock, all of which would be offered to the common stockholders outside of the be converted into 200,000 shares of common stock.[415] This increased the outstanding common stock to 600,000 shares, of which the sponsors would possess 500,000 shares. It was then proposed that an offering of 120,000 shares of common stock would be made, 70,000 shares of which would be offered to the public at $20 a share and 50,000 shares of which would be offered to the common stockholders outside of the sponsoring group at $18 a share.[416] These 120,000 shares of common stock were to be made available by the sponsors out of the 200,000 shares received upon the conversion of their second preferred stock.[417]

Charles R. Blyth, head of Blyth, Witter & Co. at the time of these transactions, testified as to the purposes and need for these changes in capital structure, as follows:[418]

Q. Will you tell me what the factors were that made you determine to do that, and what you did?

A. We had this situation confronting us. I have a rather clear notion and memory of this thing. We had a fairly heavy fixed charge to pay by way of the first preferred dividend and the second preferred dividend. Some of the directors felt, and quite properly, that it was pretty necessary to have a substantially large amount of income-bearing securities in the portfolio, sufficient to carry the charges on the senior securities, on the theory that if we didn't have more flexibility in our corporation, because at that time we hadn't built up enough surplus to really be of any great value, it seemed to us best to do away with part of these fixed charges and thereby make the corporation a little more elastic to take advantage of what we hoped would be some profitable opportunities that weren't strictly in the way of buying a bond or making a straight loan.

So we determined to convert the second preferred stock, for which $4,000,000 had been paid, into common stock on the basis of one share of preferred for five shares of common.

Q. That was only two years after you had organized the corporation, was it not, Mr. Blyth?

A. That is correct.

Q. And it was a short time after you had authorized an issue of debentures?

A. Yes.

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[414] Id., at 4662.

[415] Id., at 4654–6, 4673.

[416] Id., at 4661. The offering to the common stockholders outside of the sponsoring group was made on the basis of one share of new common for every two shares of old common held. Since 100,000 shares of common stock had been subscribed for by the holders of the first preferred stock, 50,000 shares of the new common were to be issued (Ibid.).

[417] Op. cit. supra, note 403, at 4662–4.

[418] Id., at 4653–4.

Q. So that you must have foreseen what your fixed charges would be?

A. Well, I think—and this is more from my memory than a positive statement of fact—that the thing didn't begin to develop by way of foreign opportunities to the extent we thought they might, and we were following a rather new route that hadn't been gone over before, and it wasn't unreasonable to find it necessary to perhaps change some of our original ideas as to the best way to work this organization, and I think to give ourselves greater latitude we determined to make that conversion.

The proposed public sale of a part of the common stock thus received in exchange for the second preferred stock played no immediate part in the scheme to reduce the fixed charges. Gerald F. Beal, vice president of J. Henry Schroder Banking Corporation at the time in question, testified as follows with respect to this feature of the plan:[419]

Q. What were the factors that made you determine to pass on a part of that investment to the public, at the time that 125,000 shares of common were offered, in January of 1929?

A. I think the main factor was that we were very much interested in the development of the market for the common stock, and we had felt that over a period of time the common stock of this company was going to represent a pretty substantial asset value, and we felt that at that time, to get a wider distribution of the stock, and establish a real market for it, was of benefit to the company.

Q. In what way, Mr. Beal?

A. I presume that we envisaged that further amounts of common stock might be sold later on.

Q. And that distribution in 1929 would assure a good distribution at a later time?

A. Exactly.

This plan to improve the market for the common stock was also of benefit to the sponsors, who still possessed a substantial interest in such shares.

On November 19, 1928, a special meeting of the second preferred and common stockholders was called to approve the plan. Since the bankers held 75% of the Corporation's outstanding common and all of the Second Preferred stock, there could be no doubt as to the outcome. The plan was adopted and the charter appropriately amended.[420]

The mechanics of the distribution to the public were carried out through buying and selling groups. The European banks deposited 81,000 shares of common at $17 per share with a buying group composed solely of Blyth, Witter & Co. and J. Henry Schroder Banking Corporation. The buying group then added 39,000 shares and turned over to a selling group of 120,000 shares of common stock at $18.50 a share. Thus, Blyth, Witter & Co. and J. Henry Schroder Banking Corporation received $18.50 per share for their 39,000 shares of new common stock and the European group received $17 per share for the balance.[421] Accordingly, the American and European sponsors realized $2,098,500 from the sale of the 120,000 shares, thus reducing

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[419] Id., at 4799.

[420] Ibid. The voting trust under which the sponsor's original 300,000 shares of common stock had been deposited was terminated at that time (Id., at 4615).

[421] Op. cit. supra, note 403, at 4668.

their original investment of $4,000,000 by more than half.[422] The 380,000 shares of common stock retained by them represented 63.3% of the voting power.[423]

The selling group, comprised of the same American sponsors, in turn sold to the public at $20 a share the entire 120,000 shares received from the buying group, plus an additional 5,000 shares supplied by Blyth, Witter & Co. out of other holdings.[424] The profit to the selling group upon the 120,000 share block therefore represented an additional $301,500.

There were also sold under the rights issued to the old common-stock holders of American, British & Continental Corporation, exclusive of the sponsoring group, 40,213 shares of common stock at $18 per share. These shares, however, did not come from the holdings of the sponsors, as originally planned. Instead, Blyth, Witter & Co. and J. Henry Schroder Banking Corporation deposited with Chase National Bank of New York 50,000 shares of the old common stock,[425] to be reserved against the exercise of the subscription rights. Blyth, Witter & Co. and J. Henry Schroder Banking Corporation then purchased in the market at a discount 40,213 shares of common stock to meet the amount of stock taken down under the rights. This discount netted them a profit of approximately $25,000 [426] and at the same time permitted the sponsors to inject support into the market.[427]

There can be little doubt that many investors may have become stockholders of American, British & Continental Corporation in reliance on the fact that the sponsors had agreed to risk their own funds in the venture.[428] However, two years after the formation of the investment company, the sponsors shifted the risk of approximately 50% of their investment to the public. Moreover, the sponsors accomplished this by selling the stock to the public at two and one-half times its cost to them.

The sponsors originally purchased 40,000 shares of second preferred and 300,000 shares of common stock in units of one share of preferred and seven and one-half shares of common at $100 per unit. Each share of second preferred stock was then converted into five shares of common stock, so that the sponsors ultimately received 12½ shares of common for $100, or at a cost of $8 per share. The American sponsors thereupon sold 120,000 shares of the stock so received to the public at $20 a share when its net asset value was only $6.82 a share.[429] Despite these disparities, Mr. Beal refused to admit that the $20 price was unfair or exorbitant under the circumstances.[430] While the stock

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[422] Id., at 4673. As these 120,000 shares cost the sponsors only $960,000 they realized a profit thereon of $1,138,500.

[423] Id., at 4673–4.

[424] Id., at 4665.

[425] These securities were then released from the voting trust (Id., at 4666).

[426] Op. cit. supra, note 403, at 4666.

[427] In 1929 the price of this stock declined rather steadily, falling as low as 14¼ in August of that year (Id., at 4679). This decline took place in a period when investment trust shares, in general, were participating in the general stock market rise. The Standard Statistics monthly average of 18 investment trust company stocks declined from 332 in January to 323 in April, but by August was at 407. During this 8-month period, when the sponsors were covering part or all of the 40,213 shares they had supplied to shareholders, only 50,400 shares were reported sold on the New York Curb Exchange.

[428] Op. cit. supra, note 403, Commission's Exhibit No. 447.

[429] Id., at 4698.

[430] Id., at 4800.

had earnings and leverage which might have given it a market value in excess of its net asset value, the fixing of such a price could only be a matter of estimate and in this case all the estimating was done by those who would get the profit. The natural inclination was therefore to sell the shares at a price as high as the market would bear.

Furthermore, there was no unequivocal disclosure that the banker-sponsors were the owners of the second preferred stock and would substantially reduce their investment in American, British & Continental Corporation as a result of the redistribution.[431] Nor did the offering circular disclose the disparities existing between the offering price and the cost and liquidating values.[432]

General American Investors Company, Inc.

On January 25, 1927, an investment company known as General American Investors Company, Inc., was organized under the joint sponsorship of Lehman Brothers and Lazard Frères, investment bankers. The public offering consisted of $7,500,000, 25-year 5% debentures. Each $1,000 debenture carried a warrant for 10 full-paid shares of common stock which could not be detached prior to the record date for the initial dividend upon the common stock without the consent of the board of directors.[433] The total selling commission of $225,000 was deductible from the offering price of $7,500,000 for the debentures.[434]

At the same time the sponsors agreed to purchase $1,500,000 face amount of 6% cumulative preferred stock and 125,000 shares of common stock for a total consideration of $1,800,000.[435]

By resolution of the board of directors of General American Investors Company, Inc., the warrants were declared exercisable on and after February 15, 1928, or approximately one year after the public offering of the debentures.[436] Up to that time the sponsors had complete control over the available supply of common shares and no market could exist except as they disposed of their holdings. Even after that event the available supply was increased by only three-eighths of the total outstanding common stock.

In the first quarter of 1928 the market price of the stock ranged from 56⅛ to 68¾, while the stock had an asset value of $12.15.[437] While these prices, representing premiums of from 365% to 468%,[438] were in part a reflection of the times and of the leverage nature of the company's capital structure, the small floating supply of this stock probably contributed to this premium. The market price of this stock experienced a gradual rise through May 1929, when the price

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431 Id., Commission's Exhibit No. 453. It was stated in the offering circular in small type that "This offering does not represent new financing on the part of the Corporation," and mention was made that "holders of the Second Preferred Stock have agreed with the Corporation to cause this public offering of the Common Stock to be made."

432 Id., at 4678.

433 Op. cit. supra, note 194, at 5726, and Commission's Exhibit No. 517.

434 Id., Commission's Exhibit No. 517.

435 Ibid.

436 Id., at 5727.

437 Derived from supplementary information supplied the Commission for General American Investors Company, Inc.

438 Reply to the Commission's questionnaire for General American Investors Company, Inc., Pt. II.

ranged from 79½ to 88—prices well in excess of the asset value throughout that period.

On May 28, 1929, the preferred stock sold to the sponsors was retired at par plus accrued dividends.[439] On the same date there was declared a 100% common stock dividend, increasing the number of outstanding shares from 200,000 to 400,000, and at about the same time 400,000 additional shares were offered to stockholders at $15 a share, without underwriting commission, quadrupling the outstanding common shares and giving a net increase in equity backing for the debentures of approximately $4,250,000.[440]

Although the sponsors of this investment company appear to have taken an active part in the market for this common stock after the third quarter of 1928, a dominant position was at all times maintained by the sponsors in the common stock.[441]

Second General American Investors Company, Inc. was organized by Lazard Frères and Lehman Brothers (the sponsors of General American Investors Company) on October 15, 1928, at which time these sponsors made a public offering of $10,000,000 6% cumulative preferred shares with option warrants for 200,000 shares of common stock. These securities were sold at $102.50 per unit—a unit consisting of one share of preferred stock and option warrants to purchase two shares of common stock.[442] The option warrants were exercisable during the period beginning in 1930 and expiring at the end of 1934, at prices ranging from $10 to $15 a share and were not otherwise detachable.[443] At the same time the sponsors subscribed to 300,000 common shares at $10 a share, while another 200,000 shares were reserved to the common stockholders of the first investment company at the same price, giving those sponsors a total of 425,000 shares out of the 500,000 shares offered.[444] Finally, 25-year options to purchase 500,000 common shares at prices ranging from $10 to $20 [445]

[439] Id., Pt. V.

[440] Ibid., and op. cit. supra, note 194, at 5745–7.

[441] Schedule of purchases and sales by the sponsors of General American Investors Company, Inc., in the common stock of the first company:

	Bought		Sold		Total reported sales
	Number of shares	Cost	Number of shares	Proceeds	
February 1927: Original subscription with 15,000 shares preferred	125,000	$305,000.00			
June 1927	370	5,049.53			
September 1928	1,100	68,857.50	3,680	$252,062.78	10,300
December 1928	3,670	224,936.25	18,620	1,365,221.18	108,100
March 1929	2,800	213,742.50	500	43,261.25	31,000
June 1929 stock dividend	114,300				
June 1929	11,300	875,248.75	6,300	493,761.75	29,000
Sept. 5, 1929, subscription	5,700	146,201.25			28,000
	235,700	3,535,500.00			
Total	499,940	$5,374,535.78	29,100	$2,154,306.96	

Source: Derived from supplementary information supplied the Commission for General American Investors Company, Inc.

[442] Op. cit. supra, note 194, Commission's Exhibit No. 525.

[443] Ibid.

[444] Ibid.

[445] These prices were allocated to blocks of stock called for by the option warrants as contrasted with the time element in the price to be paid under the option warrants publicly distributed.

a share were divided equally between the two sponsors as a form of management compensation.[446]

The option warrants attached to the preferred stock offered no source of common shares available for trading until the end of 1929 and thereafter only 220 shares were issued thereunder. Accordingly, during the period of the greatest trading and most inflated prices only 75,000 common shares were in the hands of the public, while the sponsors owned 425,000 shares with option warrants to purchase 500,000 additional shares. Although the leverage factor in the capital structure of this investment company was considerably less than originally existed in the first enterprise, the common shares were substantially tied up with the sponsors.

The common stock was listed on the New York Curb and trading began on October 17, 1928, two days after public offering.[447] During the period from original listing to the end of 1928 the stock ranged in price from 24½ to 33, while its asset value was only $13.72 at the end of 1928.[448] The market price was about 240% of asset value or a premium of approximately 140%.[449] The market prices of these shares thereafter, until the merger on September 5, 1929, were largely within the 1928 range and, after the split-up of the shares of the first company in May 1929, the quoted prices for the two stocks were substantially the same.[450]

The sponsors were more active in the distribution of their own shares in the case of the second company, but most of their sales were made off of the exchange.[451] Thus, 148,175 shares of the 178,165 shares of the second company sold by its sponsors in the last quarter of 1928 were sold off of the exchange by direct transactions. About 71,000 of these shares were sold to individual directors of the company, and an additional 78,000 shares were sold in large blocks to undesignated persons.[452] Similarly, in the first quarter of 1929, the sponsors disposed of 25,500 shares, of the total of 27,325 shares sold by them, through private placing.[453] These direct transactions were made at prices averaging around 16 or 17, as compared with the price of $10 a

[446] Op. cit. supra, note 194, at 5747–50. In this instance the underwriting commission was fixed at $175,000 plus selling expenses for the preferred stock, with the limitation that the commission, selling expenses and organization expenses should not exceed $250,000 (Id., Commission's Exhibit No. 525).

[447] Id., at 5762.

[448] Ibid., and op. cit. supra, note 437.

[449] Op. cit. supra, note 438, Pt. II.

[450] Op. cit. supra, note 437.

[451] Schedule of purchases and sales by the sponsors of General American Investors Company, Inc., in the common stock of the second company (ibid.):

	Bought		Sold		Total reported sales
	Number of shares	Cost	Number of shares	Proceeds	
December 1928 subscription	{ 425,000 4,400	$4,250,000.00 118,440.00	178,165	$3,004,818.04	53,500
March 1929	6,325	113,658.75	27,325	747,073.76	65,000
June 1929	18,700	542,226.25	11,100	255,435.25	48,000
September 5, 1929	9,300	246,648.75	6,000	174,297.50	21,000
	463,725	5,270,973.75	222,590	4,181,624.55	----------

[452] Op. cit. supra, note 194, at 5763.

[453] Op. cit. supra, note 437.

share paid to the investment company. At the same time the purchasers were getting the stock for at least $8 per share less than the market price.[454]

Thereafter, on September 5, 1929, the first investment company was merged into the second investment company under the name of General American Investors Company, Inc.[455] The common shares of the first investment company were exchanged, share for share, for the stock of the second company, while the debentures of the first investment company were assumed by the second company.[456]

The foregoing details, concerning the original placing and redistribution of the common shares of the two General American Investors Companies, indicate the problems presented by the concentration of such shares available for trading in the hands of the sponsors, largely through the device of unit offerings. There was also a specific agreement between the sponsors that the common shares held by them in either company should not be sold by one sponsor without the consent of the other.[457] This agreement had no application to the sale or exercise of their option warrants.[458] While these sponsors apparently did not engage in extensive trading activities in these shares, they realized considerable profits. Estimating profits on the basis of the average cost of securities which were sold during the period, from original flotations to September 5, 1929 (the date of the merger between the two companies), the sponsors realized in connection with the original General American Investors Company, Inc., profits of approximately $2,000,000, and in the case of the second company, profits of $1,900,000. In addition, the sponsors had unrealized profits on September 5, 1929, equivalent to about $6,500,000 in the case of the first company and $3,000,000 in the case of the second company.

III. PROBLEMS IN CONNECTION WITH THE REPURCHASE OF THE SHARES OF CLOSED-END MANAGEMENT INVESTMENT TRUSTS AND INVESTMENT COMPANIES

A. General Characteristics of Repurchases

Although a primary objective of sponsors of closed-end management investment trusts and companies was to have these companies distribute large quantities of their security issues in order to collect extensive funds for their management and control, a variety of circumstances and influences impelled these sponsors to cause these investment trusts and companies to repurchase or reacquire large blocks of their outstanding securities, thereby reducing the amounts of the funds under their supervision.

During the years 1927 through 1935 closed-end management investment companies proper and investment-holding companies repurchased some $534,000,000 of their own outstanding securities of which they resold $61,000,000, resulting in net repurchases of about $472,000,000. These net repurchases equaled about 12% of the value of

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[454] Ibid.

[455] Op. cit. supra, note 194, Commission's Exhibit No. 528.

[456] Ibid., and at 5745–6.

[457] Id., at 5764–6.

[458] Ibid.

total sales of the security issues of these types of investment companies.[1] These total repurchases included approximately $321,000,000 of preferred stocks, some $99,000,000 of bonds, together constituting about 79% of total repurchases of all classes of securities, and $114,000,000 of common stocks. Since the senior securities issued were relatively less in dollar volume than common stocks sold, these repurchases, as percentages of proceeds from original sales, represented 29% of the bonds sold, 25% of the preferred stocks sold, and only 5% of common stocks sold. Resales were most concentrated in the common stocks.

The condition of the market during the 1927–1935 period was an influential factor in the repurchase operations of closed-end management investment trusts and investment companies in their own securities.[2] Obviously, repurchase programs during the rising markets of 1928 and 1929, when such securities frequently sold at market premiums (at market prices above asset values), were based upon different inducements and justifications from those which prevailed during the period of severe market decline of the following years, when such securities ordinarily sold at market discounts (at market prices below asset values).[3] Thus, repurchases were particularly heavy in the period from the end of 1929 through 1932 and approximately one-third of total repurchases were effected in the year 1930, alone.[4] Furthermore, it was rare that repurchases of securities were effected at their call prices.[5]

Various explanations and justifications were urged by the managers of closed-end management investment trusts and investment companies for their repurchase operations: to "peg, fix, or stabilize" the market during the primary distribution of new issues; to "police" and maintain an orderly market in the securities; to supply a better market for the security holders who, because of financial conditions had to sell their shares—distress selling by security holders; to simplify or adjust the capital structures; to increase or decrease leverage;

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[1] The statistical data contained in this section are derived from Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 232–41, and are subject to the limitations and conditions as therein set forth. These figures may be compared with total repurchases by closed-end investment companies proper (exclusive of companies in The Equity Corporation and Atlas Corporation groups) of $315,757,000 and total resales of $37,369,000 (Id., Tables 74, 75, 76, and 77). Such repurchases in this group constituted a net reduction of 16% of total security sales (Id., Tables 61 and 64).

[2] For a further discussion of the effect of market conditions upon repurchases, see id., p. 236.

[3] The price fluctuations, premiums, and discounts experienced by security issues of closed-end management investment trusts and investment companies are discussed in Pt. Two (House Doc. No. 70, 76th Cong.), Ch. IV, pp. 310–24.

[4] Id., Ch. III, Table 64.

[5] An example of the use of the redemption power was provided by Financial and Industrial Securities Corporation. A notice was sent to the holders of the 7% preferred stock of Financial and Industrial Securities Corporation on December 1, 1928, advising them that the 150,104 preferred shares outstanding would be redeemed at $110 a share on January 1, 1929, unless converted into common stock by December 10, 1928, on the basis of one share of preferred stock for 8/9 share of common stock (Public Examination, Financial and Industrial Securities Corporation, Commission's Exhibit No. 3008). The over-the-counter market price of the common stock was 129–138½ for the month of December 1928 and holders of the preferred stock were not advised that the asset value of the common stock was about half the market price (Id., Commission's Exhibit No. 3020). Holders of 142,628 8/9 preferred shares or 95% of the preferred shares outstanding, converted them into 128,366 common shares on the basis of this offer (Id., Commission's Exhibit No. 3006).

to assist the consummation of mergers and consolidations; to create book "profits" by purchasing the securities below asset values; to prevent the operation of "touch-off" clauses in debenture agreements; and to reduce interest charges.[6] This section will attempt to explore the merit and force of these purposes by discussing actual repurchase operations engaged in by various investment companies. The discussion of the problems in connection with the distribution of securities of closed-end management investment trusts and investment companies contained in the preceding section has already indicated a variety of repurchase practices, particularly such repurchases which were a part of the distribution plan.

B. Influencing the Market Through Repurchases

Although the underlying values of security issues of closed-end management investment trusts and investment companies were more definitely ascertainable than the net worth of many industrial enterprises, such issues were subject to price variations as was any stock or bond seeking a market. As a group, investment trust and investment company securities led the market both during the rise in 1928 and 1929 and in the decline of later years.[7]

It will be recalled that management investment companies of the closed-end type, unlike fixed trusts or open-end investment com-

[6] The statement of the committee on stock list of the New York Stock Exchange adopted April 22, 1931, concerning investment trusts of the management type included the following (for full text see Pt. Two [House Doc. No. 70, 76th Cong.], Ch. IV, Appendix E, of this report):

I. Reacquisition of Outstanding Securities.

The general question of the propriety of an Investment Trust reacquiring its own securities has to be viewed in the light of the capital structure of the company in question and of the purpose for which the reacquisition has been undertaken. In the matter of capital structure, companies can be divided broadly into two classes: Those having prior securities outstanding and those having merely common stock outstanding.

In the case of companies having prior securities outstanding, the reacquisition of outstanding bonds appears in general unobjectionable.

The reacquisition of outstanding preferred shares would appear to be unobjectionable:

(a) for the purpose of retirement;
(b) for the purpose of resale under proper provisions to management in connection with management plans;
(c) for the purpose of reissue in connection with plans of consolidation or merger;

provided that in each instance the stock reacquired had been purchased at a fair price, and that its reacquisition had not impaired substantially the equity behind any outstanding securities senior to it in character.

The reacquisition of common shares would appear in most cases to be open to the objection that it would tend to reduce the equity in back of prior securities upon which the holders of these securities are justified in relying. Where common stock is reacquired for the purpose of prompt reissue in connection with the acquisition of assets, this objection may lose its validity.

In the case of companies having only common stock outstanding, the reacquisition of such stock appears unobjectionable when acquired:

(a) for the purpose of retirement;
(b) for the purpose of resale under proper provisions to management in connection with management plans;
(c) for the purpose of reissue in connection with plans of consolidation or merger;

provided that in each instance the stock reacquired had been purchased by the company at not in excess of its asset value as at the date of purchase.

Nothing in the foregoing is intended in any way to suggest the approval of investment trusts carrying on operations in the nature of trading in their own securities.

In any case where profits result from the purchase and sale by an Investment Trust of its own stocks, these profits should be credited directly to capital or capital surplus and not to income.

[7] For a full discussion of such market behavior see Pt. Two (House Doc. No. 70, 76th Cong.), Ch. IV, pp. 310–24.

panies, are under no obligation to redeem their securities. Security holders of closed-end investment companies who desired to sell their securities ordinarily had to dispose of them in the open market at prices which were affected by bona fide supply and demand on the part of investors and by market operations by professional traders, the investment companies or insiders. Prior to the market collapse of 1929, repurchases by investment companies served to aid the sponsor in the original distribution of the investment company's issues, and in secondary market operations thereafter, to prepare the market for additional financing, to put the price of the security at a level with other investment company issues which the sponsors believed or stated were comparable issues, to "police" the market or to influence security holders to affect exchanges, etc.[8]

1. REPURCHASES IN AID OF DISTRIBUTIONS

If shares similar to the ones being offered for public subscription could be purchased in the open market at a discount the offering would of course be unsuccessful. However, if the shares were selling upon the market at or above the offering price public confidence in the issue would be inspired. As a consequence, it was the practice of underwriters of closed-end management investment trusts and investment companies to engage in market-supporting operations—taking down all shares offered at or slightly above the offering price and reselling them if and when the market permitted. Investment bankers realized the value of maintaining such a market, even during the boom days of 1928 and 1929, in aid of their current and future distributions. They were also interested in maintaining the appearance that investment company ventures with which they were publicly associated were successful. However, these bankers and sponsors were frequently able, by reason of their controlling positions, to impose upon closed-end management investment trusts and investment companies the burden of maintaining the market for their shares, either immediately prior to or during and after distribution was in progress, despite the fact that underwriting commissions which they received were apparently adequate to cover such operations.

Illustrations of this practice have been related in the preceding sections of this chapter dealing with the distribution of security issues of closed-end management investment companies. Thus Ungerleider Financial Corporation,[9] organized by the investment banker and broker firm of Samuel Ungerleider & Company, undertook, in connection with the primary distribution of its securities, that if the sponsor permanently placed 250,000 shares the investment company would engage in a repurchasing operation in its shares through Samuel Ungerleider & Company at prices not to exceed $50 a share. Between May 1929 and December 31, 1929, 435,978 shares had been sold, netting the investment company $21,798,900. During the same period a total of 222,359 shares were repurchased by the investment company through its sponsor [10] at an average cost of $49 a share. Although the

[8] See discussion, id., Ch. III, Sec. VI, 2, pp. 236.

[9] For further details see supra, pp. 937–41.

[10] Samuel Ungerleider & Company suffered a loss of about $280,000 in these repurchase operations (Public Examination, Ungerleider Financial Corporation, at 14996).

selling group had agreed with Samuel Ungerleider & Company to take back all such shares repurchased by the investment company, only 72,549 shares were so resold for the investment company. Additional repurchases reduced the size of the investment company to 244,400 shares, for which the investment company had received $13,205,575.76. Rather than "put back" the unsold shares to the members of the selling group, with whom Samuel Ungerleider & Company hoped to do business in the future, the investment company was permitted to diminish its assets, by the repurchase of its shares, to but a little more than half of its publicized size. The underwriting commission was paid on almost all of the shares included in the original offering—or was paid upon almost twice as many shares as the investment company ultimately had outstanding at the end of the distribution period.[11]

Similar, although not so extensive, market support was supplied by Iroquois Share Corporation in connection with the distribution of its shares.[12] The brokerage firm of O'Brian, Potter & Stafford, who organized this investment company on January 14, 1929, proceeded to offer the shares of the company largely to its brokerage customers at $21.50 a share, which included a loading charge of $1.50 a share—almost 7% of the offering price. Concurrently with this offering, the sponsor firm engaged in trading operations in the shares, and in February 1930 the firm was short 4,900 shares, at an average cost of $15.73 a share. At the same time, the investment company had acquired 4.800 of its shares by repurchases at an average cost of $14.50 a share. This treasury stock of the investment company was thereupon bought by the sponsor at $15 a share to cover its short position. The market price at that time was 17–17¼.

In the case of Italian Superpower Corporation,[13] sponsored in January 1928 by American and Italian groups to raise money primarily in the United States for investment in Italian utility shares, the original public distribution consisted of a $20,250,000 debenture issue, with certain option warrants and common stock attached. On July 5, 1929, the investment company began to repurchase its debentures free of stock or warrants, in which operation it was aided by Field, Glore & Co., the American sponsors, and Banca Commerciale Trust Company, representatives of the Italian sponsors. The market price of the debentures rose from 76 on July 5 to 79 on July 16, and on July 18, when $1,469,000 face amount of debentures had been repurchased, the American bankers made an offering of $4,000,000 face amount of debentures (with certain warrants attached), one-half of which were to be obtained through this repurchase operation. Accordingly the repurchases continued until October 15, 1929, when this technically short position was finally covered. Apparently this procedure relieved the bankers from the necessity of conducting any further trading operations to support the offering. Furthermore, as in the case of Ungerleider Financial Corporation, these sponsors sold and received commissions on twice the amount of securities represented by the net contribution to the investment fund.

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[11] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 203–6, for discussion of underwriting compensation.

[12] For further details see Ch. II of this part of the report, pp. 51–76.

[13] For further details, supra, pp. 930 et seq.

United States & International Securities Corporation

The securities of United States & International Securities Corporation were distributed by Dillon, Read & Co.,[14] investment bankers, who sponsored the investment company on October 28, 1928, jointly with United States & Foreign Securities Corporation, another investment company sponsored by Dillon, Read & Co. four years previously.[15]

The capital of United States & International Securities Corporation was to be represented by 500,000 shares of first preferred stock, 100,000 shares of second preferred stock, and 3,000,000 shares of the common stock. The 500,000 shares of first preferred stock, 500,000 shares of common stock and option warrants to purchase 500,000 additional shares of common stock were sold by Dillon, Read & Co. to the public in the form of part-paid allotment certificates at $100 a unit, comprised of one share of first preferred stock, one share of common stock, and one option warrant, contemplating a total public participation of $50,000,000. Of this total, only 25%, or $12,500,000, was paid in at the time of subscription and the balance was subject to call in three installments. These units were separable into the component shares only when fully paid.[16] The first preferred stock and allotment certificates were listed upon the Boston Stock Exchange at the time of distribution and on December 11, 1929, the first preferred and common stocks were listed upon the New York Curb Exchange, although only about 71,000 shares, or 14%, of the subscribed first preferred stock, and a like number, or about 3%, of the subscribed common shares, were at that time in the hands of the public and available for trading.[17]

The second preferred stock and 2,000,000 shares of common stock were sold to United States & Foreign Securities Corporation for $10,000,000 resulting in United States & International Securities Corporation becoming a subsidiary of United States & Foreign Securities Corporation which in turn was controlled by Dillon, Read & Co.[18]

As the common stock of United States & International Securities Corporation possessed no asset value during the period 1929–1935, that investment company was advised by counsel that it could make no repurchases of its allotment certificates which included common shares.[19] However, United States & Foreign Securities Corporation did not consider itself under any disability to purchase the allotment certificates of United States & International Securities Corporation. During 1929 and 1930 United States & Foreign Securities Corporation purchased 57,700 allotment certificates, paid the unpaid balances, and received the component shares.[20] The first-preferred shares so acquired, together with other first-preferred shares bought upon the

[14] Reply to the Commission's questionnaire for United States & International Corporation, Pt. I.

[15] Reply to the Commission's questionnaire for United States & Foreign Securities Corporation, Pt. I.

[16] Op. cit. supra, note 14, Pt. I (Exhibit D) and Pt. V.

[17] Id., Pt. V and derived from supplementary formation supplied the Commission for United States & Foreign Securities Corporation.

[18] Public Examination, United States & Foreign Securities Corporation, at 11785–6, and op. cit. supra, note 14, Pts. I and V.

[19] Public Examination, United States & Foreign Securities Corporation, at 11941.

[20] Derived from supplementary information supplied the Commission for United States & Foreign Securities Corporation.

market, were thereupon sold to United States & International Securities Corporation for retirement and the common shares so acquired were sold upon the market.[21] However, Ernest B. Tracy, president of both investment companies, denied that these repurchases by the parent company and resales to the subsidiary company were the result of any agreement between them.[22] However, certain factors indicate that these repurchases may have been intended to create a very definite market reaction as a part of a general program of United States & International Securities Corporation.

The calls for the third and final installments upon the allotment certificates were made on March 1 and June 2, 1930, respectively,[23] and during the year 1930 United States & International Securities Corporation repurchased approximately 35% of the total amount of first-preferred stock acquired by it throughout the 1929–1935 period.[24] The market behavior of the first preferred and common stocks of United States & International Securities Corporation during that year appear to be more than coincidental. The first-preferred stock of United States & International Securities Corporation quoted on the New York Curb Exchange in February 1930 at 60¼, climbed to a high for the year of 75 on March 1, 1930, the date of the third call. This gain of 25% appeared in a recorded volume of trading of only 9,700 shares of the first-preferred stock. However, it is significant that during the first quarter of 1930, 48,990 allotment certificates were purchased by United States & Foreign Securities Corporation.[25]

Similarly, the common stock, which sold at 2⅝ a share in January 1930 reached a high of $8 a common share in April 1930 on a recorded volume of 5,300 shares. Again, the repurchase of allotment certificates during this period may have played an important part in the market rise in these shares.

Had the sponsors of United States & International Securities Corporation been interested only in reducing its capital it could have declared the allotment certificates fully paid and thereby avoided the hardships and further forfeitures such calls naturally entailed during that first depression year. Instead, it adopted the procedure of reducing capital by means of repurchases which served to induce the payment of calls, thereby increasing the capital.

However, while unit holders were paying off their subscription obligations at par, the investment company was repurchasing the first preferred stock at substantial discounts. Table 10 discloses the repurchase program of United States & International Securities Corporation during the 1929–1935 period:[26]

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[21] Op. cit. supra, note 19, at 11941–3. The first preferred shares taken down under the allotment certificates comprised 94% of the shares acquired through United States & Foreign Securities Corporation during 1929 and 1930 (op. cit. supra, note 15, Pt. VII [Table 40–II].)

[22] Op. cit. supra, note 19, at 11941–3.

[23] Derived from supplementary information supplied the Commission for United States & International Securities Corporation.

[24] See Table 10, infra.

[25] Op. cit. supra, note 20.

[26] Op. cit. supra, note 14, Pts. IV and V.

TABLE 10.—*Repurchases of first preferred stock by United States & International Securities Corporation*

Year	Number of of shares repurchased	Cost	Average price	Average yearly asset coverage	Market price range	
					High	Low
1928	None					
1929	5, 563	$369, 682	$66. 45	$146	$102. 00	$59. 00
1930	85, 990	5, 469, 144	63. 60	108	75. 00	28. 00
1931	71, 500	2, 455, 192	34. 34	76	60. 00	17. 50
1932	39, 000	901, 885	23. 13	61	32. 50	9. 25
1933	36, 490	1, 848, 730	50. 66	75	65. 00	17. 88
1934	7, 200	397, 283	55. 18	93	60. 38	39. 88
1935	600	34, 259	57. 10	115	80. 75	41. 25
	246, 343	$11, 476, 175	$46. 59			

In effect the investment company used approximately one-fourth of the net proceeds of $47,166,125 received from the sale of the allotment certificates to repurchase and retire about one-half of the issue of first preferred stock.[27]

In view of the negative asset value of the holdings of the sponsors during most of this period they had a special interest in securing the $12,175,150 of book profits realized upon repurchases of the senior issue.[28] On the other hand, on July 13, 1929, Dillon, Read & Co. and United States & International Securities Corporation became equal participants in a railroad joint purchasing account financed entirely by the investment company. On November 9, 1929, when the account was closed it possessed securities costing $14,261,848.36, all of which were subsequently taken down by the investment company which found it necessary to borrow $8,950,000 from United States & Foreign Securities Corporation for said purposes. As Dillon, Read & Co. may have desired to retain this position of influence in the railroads involved without the risk of further direct investment it became necessary for the allotment certificate holders to preserve the investment company assets by paying in the balances of their subscriptions.[29]

2. REPURCHASES TO AFFECT THE MARKET

Sponsors sometimes caused their investment companies to engage in repurchase operations to stimulate an increase in the market

[27] Stockholders received no prior notice of the policy of the management to engage in such large scale repurchase operations (op. cit. supra, note 19, at 11754–5). Furthermore, from 1931 up to 1935 the first preferred stock was "under water" (Id., at 11944). The problem is presented, therefore, whether the repurchases thereof by United States & International Securities Corporation did not violate the law of the State of Maryland, which provided as follows (Ch. 480 of the Laws of Maryland, 1931 [Unchanged through 1935]):

> No such corporation shall purchase any shares of its own stock unless the assets of the corporation remaining immediately after such purchase shall be not less than the debts of the corporation plus the amount of its issued capital stock, * * *.

[28] In addition, $553,997 had been paid in upon forfeited certificates (op. cit. supra, note 14, Pt. II [Exhibit A, Schedule 18]).

[29] Op. cit. supra, note 19, at 11879–80, and Commission's Exhibit No. 1166; op. cit. supra, note 15, Pt. II; and Hearings before the Senate Committee on Banking and Currency, pursuant to S. Res. 84, 72d Congress, and S. Res. 56 and S. Res. 97, 73d Congress, Pt. 4, at 1747, et seq.

prices of their security issues and as a consequence enhance the market values of the sponsors' own holdings of the investment company securities. This objective was especially attainable during the period prior to the market collapse in 1929.[30] However, the market premium often commanded by the equity shares, in which sponsors were usually invested, was a definite deterrent to such repurchases by reason of the dilution which repurchases by the investment company, at prices in excess of asset values, would effect. Such considerations apparently did not restrain repurchases by Central States Electric Corporation of its issues of convertible preferred stock at prices in excess of the call prices of the preferred stocks and the asset values of the common shares into which these preferred shares were convertible.

Central States Electric Corporation

Central States Electric Corporation was organized by Harrison Williams in May 1912, under the laws of the State of Virginia.[31] From its inception the capital structure and offerings of its security issues were so patterned that its senior securities were largely in the hands of the public who contributed substantially all of the senior money, while the common (voting) stock was largely held by that sponsor.[32] Harrison Williams steadily increased his holdings of the common stock of Central States Electric Corporation to the point where he held, through his personal holding company, New Empire Corporation, more than 95% of the total shares outstanding during 1928 and early 1929 and at least 90% in July 1929.[33] Manifestly, Mr. Williams was in a position of complete control over the investment company's affairs.

In order to finance new acquisitions, Central States Electric Corporation greatly expanded its capitalization.[34] Prior to 1928, Central States Electric Corporation had raised comparatively small amounts of capital through the sale of security issues.[35] It was during 1928 and the earlier half of 1929 that this company engaged in the raising of capital through the sale of security issues on a large scale.[36] The capital structure [37] of Central States Electric Corporation at the year ends 1927, 1928, and 1929 was as follows: [38]

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[30] See Ch. I of this part of the report, pp. 13–16.

[31] Public Examination, Central States Electric Corporation, at 12256.

[32] Id., at 12260–79, 12288–9, 12321–2, 12328–34, and 12477–80.

[33] Id., at 12315, and Commission's Exhibits Nos. 1205 and 1207.

[34] Central States Electric Corporation's initial asset was a block of the common stock of Cleveland Electric Illuminating Company which it held until 1922 (Id., at 12289–90 and 12310–11). Early in 1922 it disposed of its holdings in Cleveland Electric Illuminating Company, receiving in return cash and stock of the North American Company (Id., at 12290–2, 12301–3, and 12313). From that point forward, Central States Electric Corporation maintained an increasing interest in the North American Company (Id., at 12380–1, 12386, 12398–404, 12415, and 12482–91).

[35] For discussion of financing from the formation of Central States Electric Corporation in 1912 through 1927, see op. cit. supra, note 31, at 12256–72, 12278–93, and 12380–403.

[36] For financing by Central States Electric Corporation over this period see op. cit. supra, note 31, Commission's Exhibit 1233.

[37] Reply to the Commission's questionnaire for Central States Electric Corporation, Pt. II (Balance Sheet Schedules 16, 18, and 18a).

[38] Capitalization of senior securities includes relatively small amounts held in the treasury.

	1927	1928	1929
FUNDED DEBT			
6% debentures (1945)	$9,489,000		
5% debentures (1948)		$19,651,000	$19,080,000
5½% debentures			25,000,000
PREFERRED STOCK			
7% preferred	7,543,300	7,543,300	7,543,300
6% preferred		10,241,000	10,586,000
Convertible preferred (1928)		10,610,000	3,990,300
Convertible preferred (1929)			6,530,000
Total senior securities	17,032,300	48,045,300	72,729,600
COMMON			
Shares outstanding	1,090,380	1,148,881	8,508,787

The issues of preferred stocks offered in 1928 and 1929 were redeemable at $110 a share at any time at the investment company's election and both issues were convertible into common stock on the basis of one share of common stock for each $118 in par value of the preferred stock.[39] However, a 100% stock dividend on April 25, 1929, to stockholders of record on April 15, 1929, preceded the issuance of the 1929 preferred stock on June 11, 1929, so that the conversion privilege of the 1929 series was only half as attractive as the 1928 series.[40]

The common stock of Central States Electric Corporation had an exceptional rise in market value during 1928 and the first three-quarters of 1929. From a total market value of $26,200,000 as of December 31, 1927, the outstanding common stock of Central States Electric Corporation rose to the total market value of $680,000,000 as of August 30, 1929.[41] While several factors, and in particular various activities in the underlying securities of the investment company[42] contributed to this price rise, another essential element was Harrison Williams' trading activities in the small floating supply of this common stock by purchases on and sales off the stock exchange through his personally owned North American Securities Company.[43]

Because of the existence of the convertible feature in the 1928 and 1929 series of preferred stocks, any rise in the market value of the common stock would be followed by a comparable rise in the price of the convertible preferred stock. However, the preferred stock at times sold at prices below the value of the common stock obtainable from conversion of the preferred stock, which was an inducement to holders of the preferred stock to convert into common stock. Substantial amounts of this preferred stock were converted for the purpose of taking advantage of this situation, and professional arbitra-

[39] Op. cit. supra, note 31, Commission's Exhibit No. 1228.

[40] *Poor's Public Utility Section* (1929), p. 1694. Also, a 200% common stock dividend was paid July 25, 1929, to stock of record July 15, 1929. (*Poor's Government and Municipal Section*, 1930, p. 1088.)

[41] Op. cit. supra, note 31, Commission's Exhibit No. 1206.

[42] Due to various trading accounts, etc., the common stock of the North American Company and the securities of other companies in the system comprising the portfolio of Central States Electric Corporation also reflected sharp rises in market value at this time (op. cit. supra, note 31, at 12322–7, 12334–6, 12540–1, 13054–60, and Commission's Exhibit No. 1210).

[43] Op. cit. supra, note 31, Commission's Exhibit No. 1252.

geurs, in particular, were buying this preferred stock below its conversion value, selling the common stock short, and using the common stock received from the converted preferred stock to cover their short positions. The effect of this interest of professional arbitrageurs in the market was to depress the market price of the common stock at a time when the purpose of Mr. Williams' activities in the market was to raise the price of the common stock of Central States Electric Corporation.[44]

Since the market value of the common stock obtainable by conversion of the preferred stock far exceeded the redemption price of the preferred, Mr. Williams, who was heavily interested in the common stock of Central States Electric Corporation, feared that to call the preferred for redemption would precipitate a large amount of conversions.[45] Thus, such a call would depress rather than increase the market value of the common stock. It became necessary to devise some means to strike a parity between the price of the common and the price of the convertible preferred. Mr. Williams testified:[46]

Q. And you were trying to prevent those conversions?

A. We were trying to prevent it from being attractive. There was one phase of that which I explained to you before, and that is the question of arbitrage, which is the sort of placing we do not like. If the price was below the parity the Street would sell the preferred—well, they would arbitrage on it. You can figure how that would work out yourself. They would arbitrage on it, which would mean the original securities would not get into the hands of the investors; they would be forced on the market.

Q. Let us see what would happen. They would buy the preferred and sell the common short?

A. Yes; then they would convert and get the common to make delivery.

Q. So if the preferred stock was out of line with the conversion rights, the effect of it would be that the arbitrageurs would buy the preferred stock and sell the common short; is that right?

A. Right.

Q. So the company took——

A. One reason in keeping the parity there was to prevent that as much as possible; to prevent arbitrage.

Q. The company [Central States Electric Corporation] took steps there to buy the preferred stock to prevent this conversion.

A. That was one of the reasons, I should judge.

Q. At the time when you took these steps to prevent arbitrageurs selling short the common stock, you were making large purchases, weren't you, in the common stock?

A. I don't remember.

Mr. Higgins. Yes.

Accordingly, in early 1929 Central States Electric Corporation was caused to enter upon a program of repurchasing its outstanding convertible preferred stock at premiums[47] although Mr. Williams

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[44] See discussion, id., at 13123–5 and 13173–4.

[45] Both series were convertible at the option of the holders at any time or within 25 days after notice of call (Id., Commission's Exhibits Nos. 1228 and 1235).

[46] Op. cit. supra, note 31, at 13123–5. See also testimony of Mr. Christian Johnson (Id., at 13173–4).

[47] It was admitted at the public examination that the policy of embarking Central States Electric Corporation upon this repurchase program was arrived at by Harrison Williams (Id., at 13158).

personally was the holder of the large block of its common stock. From February 1929 to October 1929 Central States Electric Corporation purchased a total of 48,380 shares [48] of the 1928 series of convertible preferred at a cost of $10,037,887, and sold a total of 25,633 shares for $6,143,454, making net purchases of 22,747 shares for $3,894,432, or $171.20 per share. Total purchases by Central States Electric Corporation of its 1929 series of convertible preferred amounted to 33,400 shares at a cost of $5,840,202, and sales totaled 4,968 shares for $679,209, making net purchases of 28,433 shares for $5,160,994, or $181.52 per share.

In making these repurchases, which admittedly had the effect of sustaining the market value of its common stock,[49] Central States Electric Corporation was obliged to expend substantial sums in excess of not merely the redemption values of all the preferred shares repurchased but also in excess of the asset value of the common shares which would have been issued had the repurchased shares been converted into common stock at approximately the same times the repurchases were made. The expenditure of these premiums, of course, operated to dilute the investment company's assets. Over the period February to October 1929, the total repurchases by Central States Electric Corporation of both series of its outstanding convertible preferred stock amounted to 51,179 shares, at a total cost of $9,055,427.[50] This sum exceeded the redemption value of the same number of shares in the amount of $3,425,737.[51] From February to October 1929, Central States Electric Corporation repurchased a net total of 22,747 shares or 21% of the entire issue [52] of the 1928 series of convertible preferred stock at a cost of $3,894,432.70.[53] Had these same preferred shares been converted into common stock at the time they were repurchased, the company would have been required to issue 40,863 common shares,[54] the total asset value of which would have amounted to approximately $2,142,494.[55] Of the 1929 series of convertible preferred stock, the company repurchased over the period a net total of 28,432 shares or nearly 25% of the entire issue,[56] at a cost of $5,160,-

[48] For repurchase figures see op. cit. supra, note 31, Commission's Exhibits Nos. 1253, 1254, and 1255.

[49] Id., at 13116–20, 13131, 13149, and 13160–1.

[50] Id., Commission's Exhibit No. 1255.

[51] The preferred stock was callable at $110 per share (Id., Commission's Exhibits Nos. 1228 and 1235).

[52] For amount of total issue see op. cit. supra, note 37, Pt. II (Balance Sheet, Schedules 18d and 18e). For number of shares of this issue converted, see ibid.

[53] Op. cit. supra, note 31, Commission's Exhibit No. 1254.

[54] For daily and monthly repurchases of this series of convertible preferred, see id., Commission's Exhibits Nos. 1253 and 1254, respectively. For alteration of conversion basis due to stock dividends, see *Moody's Manual of Investments, Public Utility Securities* (1929), pp. 990–1, and *Poor's Government and Municipal Section*, 1930, p. 1088.

[55] Computed on the basis of the asset value of the common receivable upon conversion at approximately the time of the repurchases and adjusted for stock dividends on the common. For asset value of the common stock over this period see op. cit. supra, note 31, Commission's Exhibit No. 1206. For total common outstanding see id., Commission's Exhibit No. 1329. The asset value of the common stock used here is the net liquidating asset value, based on Central States Electric Corporation's portfolio securities of affiliated companies taken at asset value and its portfolio securities of other companies at market value (Id., Commission's Exhibit No. 1206). If all its portfolio securities had been taken at market value, the asset value of the common stock of Central States Electric Corporation would have been somewhat increased (Ibid.).

[56] For amount of total issue and number of shares of this series converted into common, see op. cit. supra, note 37, Pt. II (Balance Sheet, Schedules 18f and 18g).

993.86.[57] Had these same shares of preferred stock also been converted into common stock at about the same time as their repurchase, the company would have been required to issue 63,084 common shares,[58] the total asset value of which would have been $1,584,494.[59] The total net cost of repurchases was therefore $9,055,427; the approximate net total asset value of the 103,947 common shares which would have been issued had this same preferred stock been converted into common stock rather than repurchased at the time was approximately $3,726,988. Thus, the difference between the price paid for the preferred stock repurchased and the asset value of the common stock obtainable had the same preferred shares been converted amounted to $5,328,439[60] and the excess price paid for the preferred stock repurchased over its call value was $3,425,737.[61]

Mr. Williams contended that these repurchases had as their primary purpose the retirement of the investment company's outstanding capital.[62] However, the circumstances of these repurchases may indicate that they were effected by Central States Electric Corporation to give market support to the common stock, a substantial block of which was owned by Harrison Williams. The issuance on June 11, 1929, in the midst of the repurchase program of new preferred stock with its less attractive conversion rights apparently was not inconsistent with that objective.[63] Furthermore, the two issues of nonconvertible preferred stock could have been repurchased much more cheaply than the prices paid for the convertible preferred shares. However, while the 1928 and 1929 series of convertible preferred stocks were demanding average prices of $171 and $181 per share, respectively,[64] the investment company repurchased only 263 shares of the 7% nonconvertible preferred stock at $115 a share for a total cost of $30,245, and 6,260 shares of the 6% nonconvertible preferred stock at $83 a share for a total cost of $520,796.[65]

In December 1929, subsequent to the repurchase activity, but prior to the retirement of the repurchased preferred stock, Mr. Williams,

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[57] Op. cit. supra, note 31, Commission's Exhibit No. 1254.

[58] For monthly repurchases see id., Commission's Exhibit No. 1254. For conversion basis see id., Commission's Exhibit No. 1233.

[59] Also computed on the basis of the asset value of the common stock receivable upon conversion at approximately the time of the repurchases and adjusted for the stock dividends on the common. For further explanation of the basis of this asset value figure, see supra, note 55.

[60] See note 55, supra.

[61] See supra, p. 964.

[62] Op. cit. supra, note 31, at 13116–19. If such was the purpose, the problem is presented whether these repurchases violated section 3781 of the corporation laws of the State of Virginia, under which Central States Electric Corporation was incorporated. This act provided that reductions of capital could be effected, after acquiring the consent of the holders of two-thirds of the voting stock, "by the purchase, at the fair market value, not exceeding par, of certain shares for retirement or by retiring shares owned by the corporation * * * ." Central States Electric Corporation expended sums representing substantial premiums over the par or redemption values of the shares repurchased.

[63] The explanation offered was that the investment company needed cash for further utility investments (op. cit. supra, note 31, at 13051–3), and that by repurchasing the series of 1928 and offering the series of 1929 the conversion rights were thereby made smaller (id., at 13140–1). As heavy resales were made when the price of the preferred was higher than the relative conversion value they served to reduce the net amount on hand and also to show a profit by reducing the cost of the remaining reacquired preferred (id., Commission's Exhibit No. 1352).

[64] Op. cit. supra, note 31, Commission's Exhibit No. 1255.

[65] Id., Commission's Exhibit No. 1253.

through his wholly-owned New Empire Corporation,[66] made a donation to Central States Electric Corporation of 1,718,995 shares of its own common stock.[67] Mr. Williams attached the following condition to this donation:[68]

that, to the extent necessary, you will accept the benefits resulting to you from our contribution * * * to reimburse you for any loss which you have incurred or may incur by reason of the purchase by you of the 22,767 shares of your Optional Division Preferred Stock, Series of 1928, and of 28,432 shares of your Optional Dividend Preferred Stock, Series of 1929, heretofore acquired by you and now held in your treasury, and that, to the extent necessary, you will apply the addition to your capital surplus resulting from our contribution of these shares to offset any such loss on your part.

Apparently Mr. Williams experienced some doubt or misgivings as to the use made of the funds of Central States Electric Corporation in repurchasing its preferred stock to support the market for its common stock in which Mr. Williams was so largely interested.

3. REPURCHASES TO "PEG" THE MARKET AND FOR BOOK PROFITS

After 1929, when market quotations for the securities of closed-end management investment trusts and investment companies experienced severe declines, and market discounts from asset values of such issues were not uncommon,[69] these companies engaged in substantial repurchase operations. As has been indicated,[70] these repurchases by the investment companies were justified by their sponsors upon the grounds: that they were of advantage to security holders by reason of the orderly markets thereby provided for their securities; that in those instances where senior securities were repurchased, the amount of outstanding senior capital was reduced, thereby cutting down the leverage in the capital structure; and that substantial "profits" were made upon such securities repurchased below their asset or liquidating values. However, other aspects of these repurchases are also of interest. The "profits" upon repurchases accruing to remaining stockholders were obtained at the expense of investors who sold their securities to the investment company at market prices below asset values. Repurchases of preferred stocks and bonds, which were so extensive after 1929 when market discounts became the rule,[71] ordinarily inured mostly to the benefit of common stockholders and the sponsors oftentimes were holders of large blocks of these common stocks. In most instances the security holder did not know, at the time of sale of his securities, the amount of the discount at which he was disposing of his holdings since he was not apprised by the investment company of the asset value of his security.[72] So, too, the

[66] Id., Commission's Exhibit No. 1207.

[67] Id., at 13242–71, 13295–306, 13359–67, and Commission's Exhibits Nos. 1263 and 1264.

[68] See letter of transmittal under date of December 6, 1929, from New Empire Corporation to Central States Electric Corporation (id., Commission's Exhibit No. 1263).

[69] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 239–40, and Ch. IV, pp. 320–4.

[70] See supra, pp. 954–5.

[71] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 236–41, and pp. 236–6, and Table 64.

[72] One instance where an effort was made to advise stockholders of the underlying value of their shares was provided by Chain Store Stocks, Inc. A letter dated December 12, 1929 (Public Examination, Chain Store Stocks, Inc., Commission's Exhibit No. 1628),

security holders were not apprised of the fact that the investment companies were engaged in these repurchase operations and investors could not determine whether the general public was in the market purchasing the securities or whether these purchases were effected by the investment company. As a consequence, discounts at which these securities were selling—discounts which in some measure reflected the confidence of the public in the management of the investment company—were lessened or eliminated. In effect, these repurchases by the investment companies, without disclosure, created the impression of confidence of security holders in the ability and integrity of the management. In that manner the sponsors of investment companies were able to use the funds of the investment company to bolster their prestige, which might be diminished if the securities of the investment companies managed by these sponsors were selling at discounts or selling at prices below the securities of comparable investment companies.

Even more important, however, is the fact that these repurchases were justified upon the ground that at the time these securities were reacquired they were the "best buys" for the investment companies as investments in which the companies could make immediate and substantial "profits." Yet the managements, who were employed by the stockholders to safeguard their interests, did not advise liquidating shareholders that their securities were selling at discounts, that they would lose upon such sale the difference between the asset value and the market value (the amount of the discount), and that the company itself was repurchasing the securities, which it considered a good investment.

Several illustrations of substantial repurchase operations by investment companies will be outlined.

Tri-Continental Corporation

On January 1, 1930, Tri-Continental Corporation and Tri-Continental Allied Company, Inc., were merged to form the new Tri-Continental Corporation with assets of $75,302,000.[73] One of the security issues of this new company was 6% preferred stock of which 433,650 shares were outstanding.[74] From January 1930 until September 1931, the investment company was actively engaged in repurchasing these preferred shares on the open market through the spon-

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advised stockholders of the asset value of their shares and the list of companies in which the assets were invested. This notification was reported in the minutes of the board of directors as of December 17, 1929, as follows:

> The Chairman stated that, after consideration of the advisability of the company's trading in its own shares, the officers had determined that it was not advisable for the company at this time to engage in such an operation, but they recommended that the company purchase a limited number of shares of its stock out of its surplus or net profits. He further stated that as the asset value of the shares of stock of the company was in excess of the present market value, it was deemed advisable to notify stockholders of the company of such asset value, prior to making any purchase, and he presented a letter dated December 12, 1929, which had been mailed to the stockholders advising them that, at market prices of December 10, 1929, the net assets of the company amounted to the equivalent of $20.73 per share, and setting forth a list of the companies in which this company had investments.

[73] Public Examination, Tri-Continental Corporation, at 18551. For discussion of the repurchase of 112,000 shares of the preferred stock of Tri-Continental Allied Company, Inc., from J. & W. Seligman & Co. for $4,100,000 for the purpose of facilitating the merger, see infra, p. 1005.

[74] Public Examination, Tri-Continental Corporation, Commission's Exhibit No. 2080.

sor firm of J. & W. Seligman & Co.[75] In the course of these operations, the investment company acquired a total of 276,233 shares, or more than 60% of the total shares originally outstanding, at an average cost of $92.18 a share.[76] During the same period 108,118 shares were resold at an average price of $90.81 a share.[77] These repurchases were made on the New York Curb Exchange until March 1930 and on the New York Stock Exchange thereafter, where they represented approximately 85% of all reported transactions in that security.[78] From April 1930 through August 1931 the price of this stock was maintained at above 90.[79]

The extent to which these transactions contributed to the pegging of this stock at that price level can readily be observed from Chart 6, on which are plotted the monthly price range of this 6% preferred stock of the Tri-Continental Corporation and the monthly closing prices of three other comparable investment company preferred issues.[80] It will be observed that the preferred stocks of other investment companies began to decline in October 1930, reached a low in December 1930, and after a recovery during a two- or three-month period, continued their decline after March 1931. However, the preferred stock of Tri-Continental Corporation fluctuated within the narrow range of 92½–94¼ in December 1930 and the price range in November was 94–94⅝. In order to achieve this stability, however, Tri-Continental Corporation bought 56,310 of its preferred shares in December 1930, more than the total volume of trading in the stock for the preceding three months or during the following eight months.[81] Earle Bailie, a partner of J. & W. Seligman & Co. and chairman of the board of directors of Tri-Continental Corporation, testified that three reasons impelled this repurchase operation by the investment company:[82]

> The reasons for this were three. First, there was the desire to place the stock in hands that would hold it. Second, there was the desire to have stock available for acquisitions. As you know, from the testimony at the private hearings, we had in contemplation a very large acquisition in that year, and we were trying to acquire a block of preferred stock that we could use for exchange. The acquisition finally fell through and the preferred stock, therefore, was left on our shelf. The third reason was that we knew that if we did not find a use for the acquired stock we could always retire it at a profit to our stockholders, which was actually the case.

An effort had been made to redistribute a portion of the preferred shares repurchased and 50,000 thereof were sold in England while

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[75] Id., Commission's Exhibit No. 2088.

[76] Ibid.

[77] Ibid.

[78] Ibid.

[79] Ibid., Mr. Bailie admitted (id., at 18722) that the repurchases of the preferred had a substantial effect in maintaining the price of that stock:

> Q. Mr. Bailie, is there any doubt that your repurchases had a very definite pegging effect on the price of the preferred stock?
> A. I do not care to use the word "pegging," but it certainly had an effect on the price of the preferred, a substantial effect.

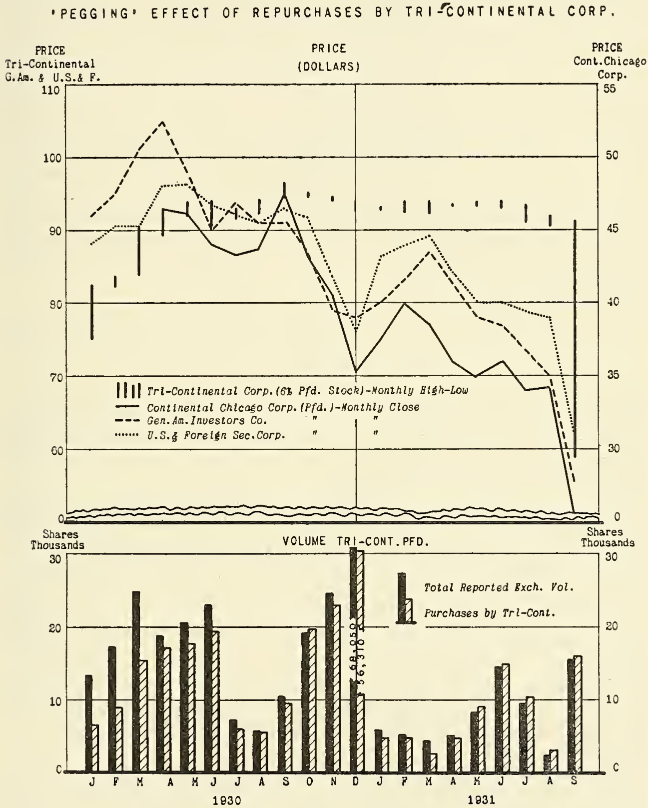
[80] Id., Commission's Exhibit No. 2087.

[81] Id., Commission's Exhibit No. 2088.

[82] Id., at 18724.

15,798 preferred shares were sold in the United States through dealers.[83] These sales were made at current market prices for which J. & W. Seligman & Co. received a commission ranging from $2 to

CHART 6



Source: *Public Examination, Tri-Continental Corporation, Commission's Exhibit No. 2087.*

$2.50 a share.[84] The investment company itself sold 21,905 preferred shares directly and 20,415 shares were sold on the exchange. During

[83] Id., Commission's Exhibit No. 2088, and derived from supplementary information supplied the Commission for Tri-Continental Corporation.

[84] Op. cit. supra, note 74, at 18719. About $1 a share was reported to be profit to J. & W. Seligman & Co. on these sales (id., at 18718), while Tri-Continental Corporation made $50,000 thereon by reason of market variations (id., at 18719–20).

September 1931, when the investment company decreased its repurchasing activities, the market price of these preferred shares broke from 91¼ to 58⅞, although the investment company bought back over 16,023 shares during this period.[85] The price range in this one month apparently indicates that the company had failed in its attempt to stabilize the market or to place sufficient of the stock in hands which would hold it so as to prevent substantial selling of preferred shares in periods of declining price levels. The anticipated merger referred to by Mr. Bailie in his testimony was never consummated [86] and not until December 31, 1930 was another merger plan worked out with Wedgwood Investing Corporation by which 27,769 of the preferred shares of Tri-Continental Corporation were exchanged for a like number of preferred shares of Wedgwood Investing Corporation.[87] The preferred shares of Tri-Continental Corporation so exchanged had been acquired at an average cost of $94 which served to off-set in some measure the unexpected high cost of the common stock acquired for the purposes of the acquisition. Nevertheless, by this exchange with Wedgwood Investing Corporation, Tri-Continental Corporation received $3,067,307 worth of assets at a cost to itself of about $3,140,000.[88]

Had these repurchases been effected only for the realization of book "profits" this could have been accomplished with a much lower volume of repurchases because the larger volume of repurchases pegged the price of the securities at a higher level and the securities had to be repurchased at these higher levels. As was testified by Mr. Bailie: [89]

Q. Do you contend, Mr. Bailie, that you could not have made substantial repurchases and made just as big a book profit by not supporting the market, by letting the market take its course?

A. If you mean, do I think I could have made a million dollars on the retirement of a smaller block of preferred stock, I could, but I would have left myself with $10,000,000 or $12,000,000 more of preferred stock outstanding. With 10 or 12 million dollars in my portfolio I would have gone down 30 or 40 percent as the company's assets went down in the next few months. Of course, if I had been omniscient, I would have cash of 100 percent from the time of the formation of the companies until June 6, 1932. At that time I would have bought a selected list of securities, such as C. & O. at 9, and I would have done quite right.

By the retirement of 137,796 shares of treasury stock, representing some 50% of the total repurchases, the investment company made a book "profit" of some $1,000,000, or approximately $7 a share.[90]

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[85] Op. cit. supra, note 74, Commission's Exhibit No. 2088.

[86] Id., at 18724. Throughout the period that the acquisition was under consideration, series of options on the preferred stock were given to J. & W. Seligman & Co. looking to the resale of these shares (id., at 18743–4).

[87] Derived from supplementary information supplied the Commission for Wedgwood Investing Corporation.

[88] As originally calculated, the cost to Tri-Continental Corporation was to be some $75,000 less than this figure, but it had been compelled to repurchase 27,160 shares of its common stock for transfer in this transaction at prices somewhat higher than it had originally calculated (op. cit. supra, note 74, at 18552–7, and derived from supplementary information supplied the Commission for Tri-Continental Corporation, Item 8).

[89] Op. cit. supra, note 74, at 18726–7.

[90] Id., at 18725, and the reply to the Commission's questionnaire for Tri-Continental Corporation, Pt. V.

This repurchase policy which entailed the employment of a third of the original assets of the investment company in maintaining a market in its own preferred stock for almost 20 months, without prior approval of or notice to stockholders,[91] and which culminated in the retirement of the greater part thereof at a net cost of about $13,000,000, or roughly 18% of the original total assets, possessed certain elements of benefit to the sponsor. Mr. Bailie testified:[92]

Q. The only other factor is that this repurchase in such large quantities helped the distribution of the securities again, did it not?

A. Yes.

Q. And to the extent that J. & W. Seligman & Company was interested in the redistribution it would help them; is that not right?

A. Yes; in various ways. First, they made about $60,000 profit on the total transaction in two years, which is about a dollar a share. Second, the fact that the stock looked well was obviously an advantage.

Q. And also the general reputation of having the preferred stock sell above the other preferred stocks added to the length of the shadow [of J. & W. Seligman Co.]?

A. That is what I just said.

In addition, this sponsor of course profited from the brokerage commissions paid upon these extensive market operations.

The Lehman Corporation

Similarly, The Lehman Corporation engaged in a repurchase program which may have redounded to the benefit of the sponsors, Lehman Brothers.

The Lehman Corporation was formed September 11, 1929 with $100,000,000 paid-in capital by Lehman Brothers, an investment banker and broker firm whose members were officers and directors of the investment company. The sponsor subscribed to 100,000 shares of the capital stock of the investment company—the company having only one class of securities—at $100 a share and sold 900,000 shares to the public at $104 a share to net the investment company $100 per share.[93]

During and following the distribution of this common stock, Lehman Brothers operated a so-called "stabilization account" in the shares on the New York Curb Exchange.[94] This account "went short" the stock while the market price of the stock continued to rise to premiums of over 25%.[95] On September 20, 1929, when the market started to decline, the account made its first purchase of 2,500 shares and, by the end of 1930, the account had acquired a total long position of 217,000 shares.[96] Only 49,000 of these shares were resold upon the exchange, the balance being disposed of off the exchange through dealers.[97] The purpose and obvious effect of such an account was to raise the market price of the shares to what the sponsors considered a "proper

[91] Op. cit. supra, note 74, at 18736–7.

[92] Id., at 18741–2.

[93] Public Examination, The Lehman Corporation, at 5314–5, 5649.

[94] Id., at 5600, 5616.

[95] Id., at 5616–7.

[96] Id., at 5599, 5619.

[97] Id., at 5600.

value." [98] The interest of Lehman Brothers in this market was revealed by Monroe C. Gutman, a partner of Lehman Brothers and vice president of the investment company, when he testified: [99]

Q. Now, why did you have this stabilization account?

A. I think you ought to get that picture from the beginning. We weren't used in 1929 to investment trust shares selling at a discount. We were used to having them selling at a premium, and if we had had any idea when we brought the Lehman Corporation stock out at $104 a share that it was going to be selling at a substantial discount from its liquidating value, we would never have sold them to the public.

Q. Why?

A. Because we didn't want to have our name on it as sponsoring it, and it was a great blow to our pride.

Q. You have also certain financial responsibilities?

A. Yes.

Q. As a firm that you lose prestige, so that at an 80 percent discount you lose quite a bit of prestige in the street?

A. I think the prestige of any banking firm that sponsors an investment trust, if it has that investment bear its name, as we did, is very much involved in the way that trust is conducted and what happens to it.

Q. Yes; so that that is not only to the interests of the shareholders but also to the interests of the firm to see that it sells not at a discount.

A. Yes; that is correct.

Despite these purchases by the Lehman Brothers' stabilization account, the shares of the investment company sold at a discount of 20% from asset value as early as November 1929, and the discount increased to 50% in 1930.[100] From September 30, 1929, through September 30, 1934, the investment company threw its support into the market by repurchasing a total of 337,300 of its common shares at a total cost of $17,130,230.[101] In the course of this repurchase program the investment company was making repurchases simultaneously with the operation of the sponsor's "stabilization account." That such purchases, which constituted a substantial part of the reported transactions on the New York Curb Exchange, must have had a definite strengthening effect on the market price of the stock which Lehman Brothers had acquired and was interested in selling was implicit in the further testimony of Mr. Gutman:[102]

Q. But isn't it the fact that if you hadn't had the repurchases by the trust of these 92,000 shares during 1930 you would have had a much greater loss in disposing of your 34,000 shares that you had?

A. Well, I would say that if the trust had not repurchased shares in 1930 the shares would have sold lower, without question; yes.

Q. They would have sold lower?

A. Yes; they would have sold lower, without question.

Q. So that there is a definite benefit in the stabilization account by the repurchases.

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[98] Id., at 5601. Lehman Brothers reported a loss of $1,250,000 in the operation (id., at 5606).

[99] Op. cit. supra, note 93, at 5609–10.

[100] Id., at 5601.

[101] Reply to the Commission's questionnaire for The Lehman Corporation, Pt. V.

[102] Op. cit. supra. note 93, at 5608.

A. I would like to put it on a broader basis, because that wasn't our motive. It was a definite benefit to all the shareholders, without question.

Q. Well, just what do you mean by that?

A. I mean the shares were worth more because of the corporation's repurchases. They would have sold for much lower if the corporation had not made its repurchases.

Although these market transactions may have accorded liquidating stockholders a better price for their shares than would otherwise have been available, these stockholders received no intimation that such a program was in progress except in the periodic reports where the repurchases already effected were disclosed.[103] The discounts from prevailing net asset values upon the reacquisition of these shares, amounting to $6,085,000,[104] were obtained for the benefit of the remaining stockholders at the expense of their retiring associates.

The repurchase operation, of course, had the incidental effect of shrinking the size of the fund without prior notice to or approval by the stockholders. Lehman Brothers, apparently, benefited from the market support afforded by these repurchase operations of the investment company to the extent that it facilitated the liquidation of the holdings of the sponsor's stabilization account. Furthermore, the apparent good performance of the investment company, as reflected in the market behavior and net asset value of its shares, also served to preserve the prestige of the sponsor. Mr. Gutman testified as follows with respect to the dual interest of sponsors involved in this situation:[105]

Q. Of course, there are certain very obvious dangers, aren't there, in a firm's being able to trade in the shares of a corporation's stock, who also use the assets of the trust to repurchase stock over the market?

Are you familiar with the English practice on that?

A. No; I am not, sir.

Q. Well, that, I believe, is taboo in England, just because of the dangers that result.

A. Yes.

Q. And I take it that you would agree that those dangers are inherent in it?

A. I would say there are probably dangers. I think that all through our life there are a great many dual responsibilities that we face.

I would like to think it over. You have raised a new problem to me. I would think that it is a danger that adequate publicity should cure.

I should think that if in 1930 Lehman Brothers had stated in their annual report that at the same time they stated they were repurchasing stock, that at the same time they were conducting a stabilization operation, no one would have been injured.

Q. It would still have given them an opportunity to use it for their own benefit.

A. I think they would have been subject to a great deal of scrutiny if they had. I think no matter how conscientious one might be, if one were of a firm of any character—and let us forget the conscience for a moment——

Q. Well, let us talk generally.

A. I think it would have a great restraint.

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[103] Id., at 5345.

[104] Op. cit. supra, note 101, Pts. IV and V.

[105] Op. cit. supra, note 93, at 5611–3.

Q. Well, that is perhaps always the case.

A. But that the possibility of some abuse exists, I must admit.

Q. You do agree with that?

A. Yes; if it is in the wrong hands.

Q. And in the hands of unscrupulous sponsors, it could be made very profitable through trading in and out, and the chances of anyone discovering it, even if you have publicity, depends on how adequate your publicity is. And, secondly, it depends on some of the stockholders having intelligence enough to read it.

A. But actually today it would be contrary to the Securities Exchange Act, today. So it is really out, as a practical matter.

Central-Illinois Securities Corporation

Central-Illinois Securities Corporation, an investment company, made available to its sponsor, in the form of a loan, $1,500,000 for the purpose of conducting market-supporting operations in the securities of the investment company; then repurchased from its sponsor the securities so acquired and finally engaged in repurchases on its own account for the alleged purpose of creating book profits.

Central-Illinois Securities Corporation was organized on October 1, 1929 to supplement the activities of its sponsor, Central-Illinois Company, the security affiliate of the former Central Trust Company of Illinois.[106] The original paid-in capital of the investment company was $15,000,000, of which $3,000,000 was subscribed by Central-Illinois Company for 600,000 shares of common stock and the balance was provided by the sale of allotment certificates for 400,000 shares of common stock and 400,000 shares of convertible preference stock, in units of one share of each class at $31.50. The public offering was made by the sponsor to the customers and stockholders of the bank.[107] The issue was oversubscribed before the offering, and there was an independent market bid as high as $42 a unit before the securities were issued.[108]

On November 1, 1929, after the break in the stock market and less than a month after the units were so oversubscribed, the sponsor commenced to repurchase the units for its own account for the purpose of providing an "orderly" market. By November 13, 1929, the sponsor had expended $1,400,000, or a sum approximately equivalent to 10% of the original paid-in capital of the investment company.[109] Philip R. Clarke, former president of the investment company, described these circumstances as follows:[110]

Q. So that in the period from November 1, 1929, to November 13, the securities affiliate had purchased $1,400,000 worth of units and that was less than a month after the offering of these units to the public; isn't that so?

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[106] Public Examination, Central-Illinois Securities Corporation, at 1848–50, Commission's Exhibit No. 236.

[107] Id., at 2126–7: see also the reply to the Commission's questionnaire for Central-Illinois Securities Corporation, Pt. V. These allotment certificates, which netted the investment company $30 each, were not exchanged for shares until September 30, 1931 (Ibid.).

[108] Op. cit. supra, note 106, at 2127.

[109] Id., at 2043–5.

[110] Id., at 2044.

A. Yes. Bear in mind, however, that it was also probably the wildest two weeks, so far as prices were concerned, that we have seen in decades, because intervening in that period was the crash of the New York Stock market.

The directors at their first meeting in November 1929 resolved to cooperate with the Central-Illinois Company to the extent of making available the sum of $1,500,000 as a loan to finance its program of purchasing the shares of the investment company.[111] At the same time the investment company authorized its president to engage in similar repurchase operations.[112]

Central-Illinois Company borrowed only $560,811 from the investment company for these purposes to April 3, 1930, and all of the units so acquired were subsequently redistributed and the loan was repaid.[113] Thereafter, the sponsor continued its purchases of the units and on January 2, 1931, commenced to offer them in blocks to the investment company at a discount from their liquidating value. The procedure adopted in this phase of the program was described in the further testimony of Mr. Clarke:[114]

In connection with the purchase of the units by Central Illinois Securities, I find that I have been in error in one instance, in my recollection, and that is that the Central-Illinois Company did not act as agent in those transactions.

I think, as a matter of fact, it has a different relationship to a matter we discussed as to the position of the stockholder, because the Central-Illinois Securities Corporation I find never bought any of these units direct from the stockholder. The stockholder made his offer in the market and the Central-Illinois Company purchased, and, after accumulating a block of these units, would then offer them to the Central-Illinois Securities Corporation, who, in their own discretion, would purchase or not purchase.

In each instance I think they purchased the units offered, because they were less than the liquidating value, and by their acquirement the company added to its capital.

It appears, nevertheless, that by the payment of a total of $944,948 for the repurchase of 40,100 of its units from January 2 to July 21, 1931,[115] when Central-Illinois Company ceased to act as sponsor, the investment company paid in excess of current market prices.[116]

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[111] Id., at 2045–6. The problem is presented whether this loan, to be secured by the investment company securities to be purchased (ibid.) was not in violation of the General Corporation Law of Delaware (under whose laws Central-Illinois Securities Corporation was incorporated). (Revised Code of 1915, as amended, Ch. 65, Art. 1, Sec. 36.)

[112] Op. cit. supra, note 106, at 2047–8. This power was not exercised (ibid.).

[113] Op. cit. supra, note 106, at 2049, 2052, 2056, 2128. As of December 31, 1929, the portfolio of Central-Illinois Securities Corporation listed 9,466 allotment certificates carried at $283,976 which were in fact received as collateral for the loan to Central-Illinois Company (reply to the Commission's questionnaire for Central-Illinois Securities Corporation, Pt. III, and derived from supplementary information supplied the Commission for Central-Illinois Securities Corporation).

[114] Op. cit. supra, note 106, at 2057–8.

[115] Id., at 2056.

[116] The units or allotment certificates were listed upon the Chicago Stock Exchange until September 30, 1931, when they became exchangeable for the component shares. (Reply to the Commission's questionnaire for Central-Illinois Securities Corporation, Pt. V [Item 49].) The following table compares the prices paid by the investment company to its sponsor with the prices quoted upon the Chicago Stock Exchange in the repur-

That these acquisitions must have provided market support is indicated by the activity during the period from January 1 to July 31, 1931, on the Chicago Stock Exchange, when approximately 50,000 units were traded.[117] It was estimated by Mr. Clarke [118] that approximately 24,000 units were repurchased by the sponsor and sold to the investment company within that period, although some of them may have been acquired over the counter. However, these repurchases were declared to have been made for the sole purpose of realizing book profits and not for the purpose of stabilizing the market,[119] Mr. Clarke testifying that he did not think "there is any necessity for an investment trust to maintain any stabilizing market." [120] This attitude contrasts with the resolution of the board of directors as a result of which a loan of $1,500,000 was authorized for such purposes.

From the date of organization to December 31, 1935, the investment company repurchased a total of 168,402 convertible preference shares, which carried as a bonus 90,213 common shares, at a total cost of $2,665,689.[121] The repurchases to December 31, 1931 were made primarily through Central-Illinois Company while the repurchases thereafter were presumably made by the investment company by direct market transaction. The book profits derived therefrom, of

chase of said units (op. cit. supra, note 106, Commission's Exhibits Nos. 256, 257, 258, 259):

Date of repurchase (1931)	Number of units	Purchase price per share	Quoted price per share
Jan. 2	16,500	24.42	23½
Jan. 6	12,000	24.76	23
Apr. 21	4,600	22.21	21¾
July 21	7,000	20.35	20

[117] Op. cit. supra, note 106, at 2059.

[118] Ibid.

[119] Id., at 2039–40.

[120] Id., at 2041.

[121] Repurchases by Central-Illinois Securities Corporation (reply to the Commission's questionnaire for Central-Illinois Securities Corporation, Pt. V):

	Convertible preference stock			Common stock	
	Number of shares	Total cost	Cost per share	Number of shares	Cost
1931	102,174	$2,075,899	$20.32	80,364	--------
1932	23,610	246,811	10.45	3,900	--------
1933	13,133	87,065	6.63	1,620	--------
1934	14,653	107,631	7.34	3,000	--------
1935	14,832	148,283	10.00	1,329	--------
Total	168,402	2,665,689	15.84	90,213	--------

some $2,000,000,[122] were received at the expense of retiring shareholders, as Mr. Clarke testified:[123]

Q. And that is, when they were making money in that way they were really making it at the expense of their stockholders?

A. Except that the stockholders——

Q. First answer yes or no and then give the exception, if you don't mind. I would like to get that. When investment trusts purchase their own securities in a falling market, particularly if they are buying them below the liquidating value of the stock, substantially, they are making that money at the expense of their retiring shareholders? Isn't that so?

A. I presume that would be the final conclusion, although I think that is a pretty severe delineation of the situation. The stockholders volunteered the securities.

* * * * * * *

Q. However, if some arrangement was present whereby a stockholder could tender his security back to the Trust and get approximately its liquidating value, he might be in a little better position. I am not saying he would. I am just thinking out loud.

A. Yes; but that is too altruistic, however. That would not be possible from a practical standpoint.[124]

C. Repurchases From Insiders

In addition to repurchases of their outstanding security issues on the open market, investment companies often reacquired large blocks of their securities from "insiders" by private purchases. Although many of the repurchases from "insiders" were on a price basis comparable to that prevailing in the open market, there were instances where they received premiums over the market price, or received less than the market price on large blocks which apparently could not have been sold on the market in such volume at the prices paid.[125]

Of 112 closed-end management investment companies proper studied (excluding companies in the Atlas and Equity groups)[126] 27 companies reported repurchases from related interests (officers, directors, principal stockholders, and their affiliated companies) of their own securities. These repurchases amounted to $26,636,000 for the period 1927–1935, representing more than 8% of the $315,757,000 total repurchases by all closed-end management investment companies proper over the same period.[127] Heaviest repurchases from related interests

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122 Reply to the Commission's questionnaire for Central-Illinois Securities Corporation, Pts. I, II, and V. Computed upon the basis of the original stated values.

123 Op. cit. supra, note 106, at 2040–1.

124 Compare with the open-end investment companies which continuously offer to purchase their shares at the liquidating or net asset values. (See I, supra, pp. 799 et seq.)

125 Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 240–1.

126 The figures appearing hereafter are derived from the replies to the Commission's questionnaire filed by the respective companies, Pts. V (Item 54–b) and VII (Item 70, Table 32).

127 Op. cit. supra, note 125, Tables 74, 75, 76, and 77. Total original sales by these companies over the period 1927–1935 amounted to $1,694,910,000. (See supra, note 1.)

were made in 1930, when they amounted to $16,458,000 or more than 12% of the total for the year.[128]

1. REPURCHASES FROM INSIDERS AT PRICES BELOW ASSET VALUE

Supporting the market by the repurchase of the security issues of closed-end management investment trusts and investment companies below asset value upon the open market was usually possible and frequently indulged in during the severe market declines following 1929.[129] Nevertheless, the type of markets then existing frequently prevented the liquidation of sizable blocks of securities without further demoralization or depression of the market prices. During this period particularly persons closely connected with the management often sold their large holdings of securities of investment trusts and investment companies to the issuing companies. These direct repurchases by investment companies were usually justified upon the grounds of the book profits which such transactions, made at about current market prices, afforded. Seldom was disclosure made to the remaining stockholders of the identity of sellers of such securities.

Allied General Corporation

An instance where repurchases were to be effected by the investment company to assist the dominant persons to pay for the control block of stock is presented by Allied General Corporation. Allied General Corporation, organized on March 22, 1927 under the name of Insuranshares Corporation of New York as an investment banking company, had suffered repeated reverses throughout its history. By December 31, 1929, the stockholders had contributed $4,456,315, which had decreased by 1931 to approximately $1,500,000. On January 7, 1931, United Founders Corporation became the principal stockholder of the company and a recapitalization increased the assets to some $3,000,000. Nevertheless, by the next year, 1932, the assets of Allied General Corporation were again only about $1,400,000.[130]

In January 1932 United Founders Corporation held 52% of the outstanding capital stock of Allied General Corporation consisting

[128] Repurchases from related interests by closed-end management investmen t companies proper were as follows:

Year	(1) Total repurchases	(2) Repurchases from related interests	Percent (2) ÷ (1)
1927	$3,607,000		
1928	2,739,000		
1929	38,367,000	$2,718,000	7.1
1930	135,314,000	16,458 000	12.2
1931	61,315,000	3,495,000	5.7
1932	30,553,000	981,000	3.2
1933	14,032,000	1,925,000	13.7
1934	10,227,000	550,000	5.4
1935	19,603,000	509,000	2.6
1927–35	315,757,000	26,636,000	8.4

[129] See supra, pp. 966 et seq.

[130] For details see Ch. IV of this part of the report, pp. 1349–56.

of 19,630 shares of preferred stock, 19,630 shares of Class A stock and 100,000 shares of common stock. These holdings, which represented a cost of $1,500,000, had an asset value of $740,000. As the preferred stock had an asset value of only $37.79 a share and possessed first call upon dissolution of $50 a share, the Class A and common stocks were without any asset value. In the fall of 1931, Chase Donaldson and a group of his associates[131] determined to acquire control of Allied General Corporation by purchasing the holdings of United Founders Corporation. Prior to January of 1932, this group had purchased and exercised option warrants to purchase a total of 34,163 shares of the common stock of Allied General Corporation. These shares, however, had been pledged by the group with the Manufacturers Trust Company to secure a loan of $20,000 made by the bank to the group to finance the purchase of the shares.[132] The Donaldson group, after some negotiation with United Founders Corporation, obtained its agreement to dispose of its holdings in Allied General Corporation for a total price of $540,000, being $27.50 per share for the 19,630 shares of preferred stock held by United Founders Corporation.[133] The Class A and common stock interest in Allied General Corporation held by United Founders Corporation were to be transferred to the syndicate free of charge. As has been indicated, these securities had no asset value. Although the price to be paid by the Donaldson group for the holdings of the United Founders Corporation group in Allied General Corporation was approximately $10 less than the liquidating value of each share of Allied General Corporation preferred stock to be sold by United Founders Corporation, the purchase price was much in excess of the then market value of the preferred stock, which was then selling in a very inactive market on the New York Produce Exchange at $8 a share.[134] The contemplated purchase price to be paid by the Donaldson group was approximately $382,785 above the quoted market value of the Allied General Corporation preferred shares to be acquired from the United Founders Corporation group.

However, Donaldson and his associates were without funds to effect the purchase of the United Founders Corporation interest in Allied General Corporation.[135] Apparently a bank loan could not be obtained without the guaranty of a financially responsible individual.

In December 1932, Chase Donaldson, largely through his half-brother, John W. Donaldson,[136] then a vice president of Atlas Corporation, enlisted the aid of Atlas Corporation in his plans to acquire control of Allied General Corporation. In January 1932, Chase Donaldson and Atlas Corporation reached an oral agreement[137] that

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[131] Public Examination, Allied General Corporation, Commission's Exhibit No. 496. Mr. Donaldson's associates were: Dean J. Almy, Herbert R. Anderson, W. F. Best, R. S. Elliott, Jr., Alfred M. Elsesser, Kenneth S. Gaston, and Eliot Sharp (ibid.).

[132] Public Examination, Allied General Corporation, at 5191–2.

[133] Id., Commission's Exhibit No. 494.

[134] During March of 1932, according to the *Bank and Quotation Record*, only 200 shares of the preferred stock of Allied General Corporation were traded on the New York Produce Exchange. The market price was $8 a share. No trading in the stock occurred in December 1931, or in January and February 1932.

[135] Op. cit. supra, note 132, at 5197.

[136] Id., at 5196, 5201.

[137] Id., at 5223, 5245–6.

Allied General Corporation after its acquisition by the Donaldson group would aid Atlas Corporation in its investment company acquisition program. Allied General Corporation was to receive a commission from Atlas Corporation for its services.[138]

Atlas Corporation further agreed to guarantee [139] a loan to be made by the Manufacturers Trust Company to Chase Donaldson and his associates in the sum of $560,000, of which $540,000 was to be used to purchase the United Founders Corporation's controlling interest in Allied General Corporation and $20,000 was to constitute a renewal of the $20,000 loan already made by the bank to the Donaldson group. The shares of Allied General Corporation acquired from United Founders Corporation were to be pledged with the bank to secure the loan.[140] In consideration of its guaranty, Atlas Corporation was to receive from the group on repayment of the loan 9,815 shares of the Class A stock and 37,500 shares of the common stock of Allied General Corporation.[141] These shares, however, were never received by Atlas Corporation, which was eventually paid by the Donaldson group for its guaranty in another manner.[142]

However, the problem of the repayment of the loan remained. To meet this problem, Chase Donaldson devised a scheme [143] whereby the control to be held by Mr. Donaldson over the corporate assets of Allied General Corporation was to be utilized to repay the loan. Briefly, the Donaldson plan was to reduce, with the stockholders' approval, the capital allocated to the preferred stock of Allied General Corporation in order to create a paid-in surplus. With this surplus, Mr. Donaldson intended to retire preferred stock of the corporation in the ratio of one share to be purchased from himself and his associates for each share purchased from the public. The Donaldson group, however, was to receive a more favorable price for its shares.[144] Further, Mr. Donaldson intended to use the prospective profits to be derived by Allied General Corporation and commissions made in effectuating exchanges of Atlas Corporation's securities for the securities of its controlled companies to purchase preferred stock, and to pay dividends on the preferred and other securities of Allied General Corporation. From these dividends and the sale of their preferred shares, funds would be available to the Donaldson group with which to pay off the loan and they would retain the Class A common stock, with its enhanced asset value and voting control. The purchase price to be paid Allied General Corporation for its preferred stock securing the loan made by Manufacturers Trust Company was to be applied by the bank in reduction of the loan.

This projected method of repayment of the loan was described to Atlas Corporation in a memorandum dated January 22, 1932, written by Chase Donaldson.[145] This memorandum states in part:

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[138] Id., Commission's Exhibit No. 495 and Public Examination, Atlas Corporation, Commission's Exhibit No. 2002, at 57.

[139] Op. cit. supra, note 132, Commission's Exhibit No. 497.

[140] Id., Commission's Exhibits Nos. 495 and 497.

[141] Id., Commission's Exhibit No. 497.

[142] See Ch. IV of this part of the report, pp. 1349–56.

[143] Op. cit. supra, note 132, Commission's Exhibit No. 494.

[144] See infra.

[145] Op. cit. supra, note 132, Commission's Exhibit No. 494.

As soon as control is acquired, a special stockholders' meeting would be called (February or March) to—

(a) Restate value of stock from $50 to $5, creating capital surplus.

(b) Authorize immediate purchase and retirement of 10,000 shares of Preferred Stock out of capital surplus so created.

(c) Authorize purchase and retirement of such additional amounts as Executive Committee shall determine, but only out of realized net profits after Preferred dividend requirements in any one month.

Note to Mr. Gibson [president of Manufacturers Trust Company]. These plans not to be known to Founders.

February to March.—Allied General preferred Class A and common stock might be listed on the Curb and the company would purchase 10,000 shares of preferred of which

5,000 shares from public 5,000 shares from syndicate	Average price less than $20 a share

Syndicate would pay off loan by $125,000 from proceeds (5,000 shares x $25) leaving a loan of $435,000 * * *

March to June.—Depending upon earnings, it would be the plan of the Syndicate to apply all net profits each month to the retirement of Preferred Stock. With present and projected business (particularly Atlas exchange) it might be possible to purchase and retire another 5,000 shares at $25 ($125,000) largely from the syndicate account, leaving loan * * * $310,000.

It will be noted that while the 10,000 shares of preferred stock which were to be purchased from the surplus created by the reduction of the capital allocable to the preferred stock, were to be acquired at an average of less than $20 a share, 5,000 of the shares to be retired were to be acquired from Mr. Donaldson and his associates at $25 a share. In other words, those in control, it was contemplated, would receive a higher price for their shares than would be paid for the shares held by the public. Further, the retirement of the corporation's preferred stock by purchases below the asset value of such stock would enhance the asset value of the Class A and common stocks held by the Donaldson group. The group would hold the majority of these securities which also constituted control of the company. Mr. Donaldson testified:[146]

Q. Substantially, this plan entailed this, did it not, Mr. Donaldson, that if you got control of the corporation, Allied General, you were going to use the funds of Allied General to pay the loan which enabled you to acquire control of the company?

A. Mr. Schenker, I object to the manner in which the question is put.

* * * * * * *

Q. Well then, what particular portion of my question do you object to?

A. Your question is misleading in this respect, in that it implies that our entire design was to take the funds of Allied General, as such, and buy in our own stock and pay off the loan. As you will see from the tenor of this memorandum it was designed that a part of our stock would be purchased, a part of the public stock would be purchased, and the balance of the loan it was expected would come from the business earnings of the company in the future business conducted.

[146] Id., at 5207–8.

Q. Let us see in what respect that question is wrong. You now say at least a substantial part of the loan was going to be repaid with the funds you were going to get from Allied General Corporation in the purchase of the preferred stock.

A. You pointed out yourself that 5,000 shares times $20 is $100,000. The total loan was $560,000.

Q. That is a pretty substantial amount.

A. That is all I have to say.

Q. At least you contemplated $100,000 of that money was going to be used for that purpose; isn't that so?

A. Yes. May I point out, however, that the price we were discussing purchasing the stock from ourselves was indicated on no particular basis but $20 a share, whereas the purchase price was $27.50 and the asset value at the time was $37.79.

Q. Why don't you follow that right through and give us the market value?

A. Let me finish what I was saying first. Let me point out that the purchase of the stock of the corporation at $20 per share, where there was an asset value of $37.79 was working no injustice on the other shareholders of the corporation.

Q. Except this, that in addition to the preferred stock which you were purchasing you had controlling common stock; isn't that so? This would leave you in control of the company after you retired your own preferred stock and the preferred stock that you were buying from the company, isn't that so?

A. Well, it is fairly obvious that if you retired all of the preferred stock, you would leave the common stock and we would be in control of the common.

On January 29, 1932, the transaction between United Founders Corporation and the Donaldson group was closed. A loan in the sum of $560,000 by the group was procured from the Manufacturers Trust Company.[147] In accordance with its agreement, this loan was guaranteed by Atlas Corporation.[148]

The connection of Atlas Corporation with the transaction and the proposed method by which the Donaldson group intended to repay the loan were intentionally concealed from United Founders Corporation. Mr. Donaldson testified that these facts were concealed from United Founders Corporation because of the fact that if United Founders Corporation had been aware of Atlas Corporation's connection with the transaction, "they might have tried to raise the price on us." Mr. Donaldson testified:[149]

Q. You say, "Note to Mr. Gibson:[150] This plan not to be known to Founders"; why not?

A. Because Founders did not have any idea how we were financing the acquisition of this stock, and we didn't care to have them know.

Q. There was no moral turpitude involved in your minds, was there?

A. Not at all, but they might have tried to raise the price on us.

* * * * * * *

Q. You said you felt if they [United Founders Corporation] knew the method by which you hoped to purchase the stock that they might increase the price?

A. Perhaps I didn't make myself clear. This is what was in my mind at the time. I felt that if the people in United Founders believed that we had a

[147] Id., Commission's Exhibit No. 499.

[148] Id., Commission's Exhibit No. 498.

[149] Id., at 5205–7.

[150] Harvey D. Gibson, the president of the Manufacturers Trust Company (id., at 5205).

highly profitable sort of business accruing to us, one or two things might have happened; either they wouldn't have sold to us or they would not have looked with any great favor on our doing business with the Atlas Corporation. To put it briefly, I was between two fears as to what course to take. It seemed logical not to disclose to the Founders group that the Atlas Corporation was guaranteeing the loan, for those two reasons I have stated to you.

Q. After all, you were an officer of Allied General at that time.

A. Yes, sir.

Q. And Founders were stockholders in that corporation, weren't they?

A. Yes.

Q. As stockholders, didn't you think you owed them any duty as to complete disclosure in connection with any transaction you were consummating?

A. I didn't think so in this case.

Promptly on their accession to control of Allied General Corporation in February 1932, the Donaldson group proceeded to carry forward their projected plan for repayment of the borrowed funds which they had used to acquire control of Allied General Corporation. On February 19, 1932, stockholders were informed by letter [151] of a meeting to be held on March 8, 1932, to consider a reduction of the capital of the corporation allocable to its preferred stock from $50 to $10 a share.[152] The net capital surplus (after creating a reserve for depreciation in value of portfolio securities) thus to be created amounted to approximately $641,000.[153] The letter stated that this surplus would be available for retirement of the corporation's preferred shares. Not revealed in the letter, however, was the method by which Mr. Donaldson and his associates had acquired control of the corporation nor the fact that the preferred shares pledged by the group to secure their loan were to be repurchased. In fact, a direct inquiry in a letter [154] dated February 25, 1932, from one Harry Buford, a preferred stockholder, as to whose shares were to be repurchased was answered without revealing the fact that the controlling group intended to use the surplus to be created to purchase their own shares as well as the shares held by the public.[155]

On March 8, 1932, the proposed reduction of the capital of the corporation allocable to the preferred stock was approved by over two-thirds of the stockholders.[156] The Donaldson group which held in excess of 50% of the shares of each class of the corporation's securities voted their stock in favor of the plan.

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[151] Op. cit. supra, note 132, Commission's Exhibit No. 500.

[152] Ibid.

[153] Id., at 5229.

[154] Id., Commission's Exhibit No. 504-A. Mr. Buford's letter stated:

> Whose stock and at what prices would be purchased is not intimated. Naturally.

With reference to the letter, Mr. Donaldson testified (id., at 5243):

> Q. Of course he [Mr. Buford] evidently didn't know that it was anticipated that at least a portion of the stock owned by the controlling interest of Allied General was to be purchased; isn't that so?
> A. You say of course he didn't know?
> Q. I mean of course the letter indicates that he didn't know because he specifically asked that question.
> A. He was advised stock was going to be purchased by the corporation but he was not advised that any of the stock was going to be purchased from any given individual.

[155] Op. cit. supra, note 132, Commission's Exhibit No. 504-B.

[156] Id., Commission's Exhibit No. 504-E; see also id., Commission's Exhibits Nos. 509-F and 509-K.

In May and July 1932, Allied General Corporation purchased from the Donaldson group 3,500 shares of its preferred stock at a price of $15 a share.[157] The market price of these shares on the dates they were purchased was approximately $8 per share.[158] The $52,500 thus raised by the group was used to reduce the loan at the Manufacturers Trust Company.[159] The discriminatory nature of these purchases by the corporation from the Donaldson group is indicated by the fact that from February 1932 to December of the same year, Allied General Corporation acquired from the public a total of 6,921 shares of its preferred stock at an average price of $12.05 per share.[160]

Ultimately, however, the plan for repayment of the loan by the Donaldson group became impossible of fulfillment for two reasons. First, under the management of Donaldson and his associates, Allied General Corporation engaged in extensive short selling of blue chip securities.[161] By July of 1932, these short sales had resulted in a loss to the corporation of over $500,000,[162] a loss sufficient to erase most of the capital surplus which had been created by the reduction of the capital allocable to the preferred stock in March of 1932. Secondly, in June of 1932, Atlas Corporation determined to make exchange offers itself of its securities for the securities of its controlled companies.[163] As a consequence, the expected profits to be earned by Allied General Corporation in effectuating Atlas exchanges were no longer possible. On December 13, 1932, Atlas Corporation paid $50,000 to Allied General Corporation in full settlement of its services in aid of the Atlas Corporation exchange program.[164]

Sisto Financial Corporation

Sisto Financial Corporation repurchased its shares from Joseph A. Sisto, a member of the sponsoring brokerage firm of J. A. Sisto & Co. This investment company was organized on August 10, 1929, with one class of capital stock for which it received $5,000,000. By the end of 1937 these assets had declined to $307,000.[165] A part of this decline in assets was due to the repurchases by the investment company of its own capital stock which possessed asset values ranging from $35.85 at the end of 1929 to a low of $11.30 at the end of 1937.[166]

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[157] Id., Commission's Exhibits Nos. 509-F and 509-K.

[158] Ibid.

[159] Ibid.

[160] Derived from supplementary information supplied the Commission for Allied General Corporation. At or about the time that the Donaldson group was purchasing its own holdings of the preferred stock of Allied General Corporation at a price of $15 a share, Allied General Corporation was offered to exchange some of its portfolio securities having a market value of $10 for each share of its preferred stock (id., Commission's Exhibit No. 509-H).

[161] Op. cit. supra, note 132, at 5249-51 and Commission's Exhibit No. 505.

[162] Id., at 5250-1.

[163] Id., at 5247, 5259-60.

[164] Public Examination, Atlas Corporation, Commission's Exhibit No. 2002 (p. 57).

[165] Reply to the Commission's questionnaire for Sisto Financial Corporation, Pt. V, and derived from supplementary information supplied the Commission for Sisto Financial Corporation.

[166] Ibid., and the reply to the Commission's questionnaire for Sisto Financial Corporation, Pt. II.

Mr. Sisto dominated and controlled the affairs of Sisto Financial Corporation as its president and through the brokerage firm which held a management contract with the investment company at all times.[167] Self-dealing with directors and the manager was specifically authorized by charter provisions if the transactions were fair and reasonable.[168] Among such transactions were sales from June 1930 through May 1934 to the investment company of 38,476 shares of its own capital stock by J. A. Sisto & Co. for a total consideration of $590,480.[169] During that period the shares were listed upon the New York Curb Exchange and the sales were apparently consummated within the range of the quoted market prices.[170] Thereafter, on January 29, 1935, after the stock had been delisted, 2,000 additional shares were sold by J. A. Sisto & Co. to the investment company for $16,000, or at $8 a share.[171]

On December 14, 1938, charges were filed with the Board of Governors of the New York Stock Exchange against J. A. Sisto alleging, among other things, that while the president, a director, and dominating and controlling the affairs of Sisto Financial Corporation, he bought 2,484 shares of such stock between July 29, 1936, and February 4, 1937, at an average price of approximately $9.78 a share and caused Sisto Financial Corporation to repurchase from him the same shares at $23 a share.[172] It was further charged that Mr. Sisto thereafter bought 1,000 shares of Sisto Financial Corporation capital stock from Kidder, Peabody & Co. through his brokerage firm from June 9 to June 16, 1937, at $15¼ a share and resold the same to the investment company at $23 a share. On December 28, 1938, the Board of Governors of the New York Stock Exchange found Mr. Sisto guilty of all charges and expelled him from membership in the Exchange.[173]

General Investment Corporation

The repurchases by General Investment Corporation of its outstanding $6 cumulative preferred stock from Wallace Groves is another example of profits made by insiders on repurchase transactions, even though those repurchases were effected at prices below asset values.[174]

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[167] Reply to the Commission's questionnaire for Sisto Financial Corporation, Pts. I and VII.

[168] Id., Pt. I.

[169] Id., Pt. V.

[170] Ibid.

[171] Id., Pt. VII.

[172] It was also charged that certain alterations had been made in the brokerage accounts of Mr. Sisto, of his firm and of the investment company; that certain recorded cash purchases to the account of the investment company were not bona fide cash transactions; that records kept of the personal trading of Mr. Sisto, of the trading by the brokerage firm and of trading by the investment company did not truly reflect the status of the accounts and liabilities incurred; and that the accounts were so altered as to cause the profitable transactions to be placed in the trading account of the brokerage firm and unprofitable transactions to be placed in Mr. Sisto's personal account.

[173] Derived from Broker or Dealer Registration file of J. A. Sisto & Co., File No. 8–1. It appears that these repurchases may have been at prices below asset values.

[174] For further details, see Ch. II of this part of the report, pp. 350–496.

In August 1936, control of General Investment Corporation was transferred to International Equities Corporation which was under the control of Ernest B. Warriner, who had been associated with Wallace Groves in his acquisition of investment trusts in 1931 and 1932.[175] Wallace Groves and his brother George Groves had lent Mr. Warriner the funds to enable him to acquire control of International Equities Corporation, which in turn, as already stated, acquired control of General Investment Corporation.

The principal asset of General Investment Corporation, when its control passed to International Equities Corporation, consisted of its holdings of the notes of Buenos Aires Central Railroad and Terminal Company which had cost approximately $14,000,000. Negotiations had been initiated by General Investment Corporation prior to its acquisition by International Equities Corporation for the sale of these notes to an agency of the Argentine Government for approximately $7,500,000. When Mr. Warriner came into control of General Investment Corporation, he and Wallace Groves selected Philip DeRonde, an associate of Mr. Groves, to complete the negotiation for the sale of these notes.

Upon the transfer of control of General Investment Corporation to International Equities Corporation in 1936,[176] all the officers and directors of General Investment Corporation, including George E. Devendorf, who was then president of General Investment Corporation, resigned and were replaced by representatives of Mr. Warriner.[177] Mr. Devendorf, then the largest minority holder in General Investment Corporation,[178] requested Mr. Warriner to cause General Investment Corporation to purchase his holdings of between 9,000 and 10,000 shares of General Investment Corporation preferred stock,[179] on the ground that he was opposed to maintaining a substantial interest in the company if he was not to be permitted to participate in its management.[180] At the time Mr. Warriner stated that he was unwilling to have any of the funds of General Investment Corporation devoted to the repurchase of its outstanding preferred stock.[181] Later, however, in November 1936, Mr. Warriner introduced Mr. Devendorf to Mr. Groves as an "unhappy stockholder" desirous of selling his stock.[182] Mr. Groves then indicated that he would not buy Mr. Devendorf's block of preferred stock as long as the notes of the Buenos Aires Central Railroad and Terminal Company remained a "frozen asset" in General Investment Corporation's portfolio.[183]

Early in December 1936, when the notes of the Buenos Aires Central Railroad and Terminal Company were sold for $5,750,000 cash and other consideration, Mr. Groves reopened the subject of pur-

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[175] See Ch. II of this part of the report, pp. 181–226.

[176] For further details and documentation, see Ch. II of this part of the report, pp. 181–226.

[177] Public Examination, General Investment Corporation et al., at 15171–2.

[178] Id., at 15175.

[179] Id., at 15184.

[180] Id., at 15181–2.

[181] Id., at 15180.

[182] Id., at 15182 and 20224.

[183] Id., at 20223–4.

chasing Mr. Devendorf's stock.[184] An offer was made whereby Mr. Groves, through his personally owned Nassau Securities Company, Ltd.,[185] would purchase no less than 17,500 shares of the preferred stock of General Investment Corporation at $87.50 per share.[186] Payment was to be made on January 25, 1937.[187] Mr. Devendorf accepted the offer, although the stock at the time had an actual liquidating value at between $140 and $150 per share.[188]

Mr. Devendorf and his family owned only 9,000 or 10,000 shares of this stock.[189] Procuring the names and addresses of the preferred stockholders of General Investment Corporation through Mr. Warriner,[190] Mr. Devendorf sent a copy on January 8, 1937, of Mr. Groves' offer to all the preferred stockholders of General Investment Corporation.[191] General Investment Corporation itself made no attempt to repurchase its outstanding $6 preferred stock either on the same or better terms than Mr. Groves' offer, although Mr. Warriner was aware of the existence of the Groves' offer at least 11 days prior to its expiration.[192] Nor does the record indicate that Mr. Warriner advised the stockholders of General Investment Corporation that the actual liquidating value of their stock was approximately $150 per share as compared with the price of $87.50 offered by Mr. Groves.[193] On the contrary, he took steps to cause General Investment Corporation both to finance the purchase of this stock by Mr. Groves, and then to repurchase the same stock from Mr. Groves at a profit to the latter.[194] Between January 18 and January 22, 1937, he requested each member of the Board of General Investment Corporation to approve a repurchase of the Company's preferred stock from Mr. Groves at $102 per share.[195]

Accordingly, on January 22, 1937, the directors approved the purchase by General Investment Corporation from Mr. Groves' personal company, Nassau Securities Company, Ltd., of not exceeding 27,000 shares of its own preferred stock at $102 per share.[196] The contract, as finally consummated, provided for the purchase from Mr. Groves by General Investment Corporation of 24,591 shares of this preferred stock at $102 per share,[197] being exactly the number of shares that Mr. Groves was able to purchase under his offer at $87.50 per share. On January 23, 1937, General Investment Corporation paid $102 per share for 20,731 shares of this stock,[198] and on January 25, 1937, Mr.

[184] Id., at 15182–3.
[185] Id., at 20295.
[186] Id., Commission's Exhibit No. 1569.
[187] Id., at 15179.
[188] I. e., $115 liquidating preference plus accrued dividends.
[189] Op. cit. supra, note 177, at 15184.
[190] Id., at 15175–6.
[191] Id., Commission's Exhibit No. 1569.
[192] Id., at 20569–70.
[193] Id., at 20656.
[194] Id., at 15187–8, 20533, and Commission's Exhibit No. 1572.
[195] Id., at 20625–7.
[196] Id., at 15203 and Commission's Exhibit No. 1571.
[197] Id., Commission's Exhibit No. 1571.
[198] Id., Commission's Exhibit No. 1575.

Groves, with a portion of these funds so obtained, in turn paid $87.50 per share for the same stock.[199]

From this transaction, Mr. Groves made a profit of $300,000 on these 20,731 shares of preferred stock which General Investment Corporation had purchased on January 23, 1937, at a price of $102 per share and for which Mr. Groves thereafter, on January 25, 1937, made payment at $87.50 per share.[200] Thus, Mr. Groves profited at the expense of General Investment Corporation by use of the investment company's funds without having been required to use any of his own money in any step of the transaction.[201]

Interstate Equities Corporation

Interstate Equities Corporation, an investment company of the general management type, was organized under the laws of Delaware on July 29, 1929,[202] by the investment banking firm of Bancamerica-Blair Corporation.[203] This investment company raised a total of $25,000,000 [204] from the sale to the public through Bancamerica-Blair Corporation for $15,000,000 of 250,000 shares of $3.00 cumulative convertible preferred stock and 250,000 shares of common stock, sold in units of one share of common and one share of preferred stock at $65 per unit, and the sale of $10,000,000 to the sponsor and an affiliate of 1,000,000 shares of common stock at $10 a share. The gross proceeds from the sale to the public were $16,250,000 from which was paid to Bancamerica-Blair Corporation a selling commission of $1,250,000, leaving net proceeds to the investment company from this offering of $15,000,000. By June 30, 1932, at the termination of the management by Bancamerica-Blair Corporation, the assets of Interstate Equities Corporation had depreciated to $4,457,000.[205]

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[199] Id., at 15188–9, 15208, and 20625–6. For the balance of the shares Mr. Groves was compelled to pay $100 per share (id., at 15187 and 20522) for which General Investment Corporation in turn paid him $102 per share (id., Commission's Exhibit No. 1576).

[200] Op. cit. supra, note 177, 20525.

[201] Id., at 20523–6. For further reference to civil action by General Investment Corporation against Mr. Groves and Mr. Warriner to recover this profit, which was settled by the payment of $145,000, and for a description of the indictment charging use of the mails to defraud, see Ch. II of this part of the report, pp. 497–623.

[202] Public Examination, Interstate Equities Corporation, Commission's Exhibit No. 2.

[203] Reply to the Commission's questionnaire for Interstate Equities Corporation, Pt. I.

[204] Op. cit. supra, note 202, at 17.

[205] The following are examples of the losses suffered by Interstate Equities Corporation during its management by Bancamerica-Blair Corporation. Purchases aggregating $6,578,036.31, or 31% of the total investments of Interstate Equities Corporation examined by the Commission, were made in securities of ten companies, some of the directors of which were on the board of Interstate Equities Corporation. Of this amount $3,615,292, or 41% of the total amount invested in these companies, was lost. In addition, by June 30, 1932, at the termination of the management by Bancamerica-Blair Corporation, a loss of $5,546,354, or 45.4% of the $12,202,231 invested in syndicates, was lost. Interstate Equities Corporation participated in some of these syndicates as a result of its affiliation with Bancamerica-Blair Corporation. For example, it participated to the extent of $2,800,000 in General Foods Corporation syndicate managed by Bancamerica-Blair Corporation and lost a total of $1,340,564. It invested a total of $508,130 in the General Theaters Equipment, Inc., preferred stock as a result of a syndicate managed by the Famoth Corporation, a personal holding company of Edward R. Tinker, and which resulted in a net loss of $467,890 to Interstate Equities Corporation. Interstate Equities Corporation lost $793,954 out of a total investment of $825,904 as a participant in a syndicate headed by Bancamerica-Blair Corporation, formed to get control of Tidewater Associated Oil Co., a company in which officers and directors of Bancamerica-Blair Corporation

Of the consideration received for the units sold, $50 per share was allocated to the preferred stock and the balance to common stock and paid-in surplus.[206] The sponsor's underwriting commission on the issue of the units amounted to $5 per unit,[207] or a total of $1,250,000, 8% of the total capital contributed by the public.

Of the 1,000,000 shares of common stock sold to the Bancamerica-Blair Corporation, 500,000 shares of this common stock was sold directly to this sponsor at $10 per share plus an amount sufficient to pay part of the expenses of the organization of Interstate Equities Corporation.[208] In addition, as will be shown later, Bancamerica-Blair Corporation acquired, through the Suffolk Corporation, another 200,000 shares at the price of $10.15 per share.[209]

Edward R. Tinker, president of Interstate Equities Corporation [210] and director of Bancamerica-Blair Corporation, justified the preferential treatment accorded the bankers on the ground that it was necessary to compensate the sponsors for their expenses. Actually, however, organizational expenses amounted to $150,000,[211] of which Bancamerica-Blair Corporation paid only $75,000. Furthermore, as has been indicated, the underwriting contract provided that Bancamerica-Blair Corporation was to pay these organization costs [212] from the underwriting fee of $1,250,000.

The remaining 500,000 shares of common stock were sold to Suffolk Corporation, whose stockholders consisted for the most part of offi-

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were interested, and to consolidate it with the Sinclair Consolidated Oil Company, for which Bancamerica-Blair Corporation was the banker. (For detailed discussion of this syndicate see Ch. II of this part of the report, pp. 227–308.) The investment company also lost $569,725 out of a total participation of $678,425 in the Rio Grande syndicate, also formed by Bancamerica-Blair Corporation apparently to procure the banking business to follow from a contemplated merger of Sinclair Oil Company, Tidewater Oil Company, Rio Grande Oil Company, and Barnsdall Corporation, all oil companies in which officers and directors of Bancamerica-Blair Corporation and/or their affiliated investment company, Petroleum Corporation of America, were interested (ibid.).

On October 7, 1931, Bancamerica-Blair Corporation sold to Wallace Groves 542,517 shares of the common stock of Interstate Equities Corporation at $1.50 per share for a total of $813,775.50. By virtue of this purchase and an additional 100,000 shares purchased from Hunter Marston, a director of both Interstate Equities Corporation and Bancamerica-Blair Corporation, Wallace Groves acquired 46% of the voting stock of Interstate Equities Corporation. At this time, the assets of Interstate Equities Corporation had depreciated to $8,636,431, a decline of approximately 65% from the amount of the funds originally contributed to Interstate Equities Corporation. This value was arrived at by taking the company's investments in stocks and bonds at market or estimated fair value. By October 20, 1931, $2,443,379 had been returned to stockholders as the result of the repurchase of 76,738 shares of preferred stock for which the company had originally received $3,836,900.

For a detailed discussion of the management of Interstate Equities Corporation by Wallace Groves, see Ch. II of this part of the report, pp. 181–227.

[206] Op. cit. supra, note 202, Commission's Exhibit No. 14.

[207] Ibid.

[208] Id., Commission's Exhibit No. 6. The contract also stated that to the extent these expenses were paid by the Suffolk Corporation or purchasers from the latter, Bancamerica-Blair Corporation was to be relieved from paying the organization's expenses (id., Exhibit No. 6, par. 2). Ultimately half of the expenses were paid by Suffolk Corporation and purchasers found by it, so that Bancamerica-Blair paid only $10.15 per share for the common stock.

[209] Op. cit. supra, note 202, at 675.

[210] Id., Commission's Exhibit No. 16.

[211] Id., at 674.

[212] Id., Commission's Exhibit No. 5.

cers, common stockholders, and associates of Blair and Company,[213] the predecessor of Bancamerica-Blair Corporation, at $10 per share plus a pro rata share of the organizational expenses of Interstate Equities Corporation. These expenses amounted ultimately to 15 cents per share.[214] Suffolk Corporation in turn distributed this stock to a selected or preferred list of investors who acquired the stock at about $10.50 per share as compared with the $15 price per share to the public.

The selected or preferred list consisted of the officers and directors of Bancamerica-Blair Corporation, Bank of America (at the time closely affiliated with Bancamerica-Blair Corporation),[215] and Interstate Equities Corporation. The directors and officers of Bank of America [216] purchased 46,000 shares of the common stock of Interstate Equities Corporation. Officers, directors, and employees of Bancamerica-Blair Corporation and Interstate Equities, through personal holding companies, purchased an additional 254,000 shares.

Bancamerica-Blair Corporation, the sponsor, in addition to the 500,000 shares of common stock acquired directly from Interstate Equities Corporation, purchased 200,000 shares of common stock from Suffolk Corporation at $10.15 per share.[217] Bancamerica-Blair Corporation subsequently made these 200,000 shares available to dealers at $15 per share.[218]

During the period that Bancamerica-Blair Corporation managed Interstate Equities Corporation (1929–1932), the investment company repurchased approximately 40% of its outstanding preferred stock. Up to June 30, 1932,[219] the investment company retired 98,528 shares out of the 250,000 shares originally outstanding.[220] These repurchases were made at a total cost of $2,663,991.50 [221] or at an average price of $27.04 per share.

A substantial part of these repurchases were made during a period of declining security prices directly from the sponsor who had a substantial block of the preferred stock. From March 5, 1931, to May 13, 1931.[222] Interstate Equities Corporation repurchased from Bancamerica-Blair Corporation, acting for its own account and not as brokers, 35,975 shares of its preferred stock for a total price of $1,055,787.50, at an average cost of $29.31 per share. Interstate Equities Corporation had previously repurchased 5,875 shares of its preferred stock directly from Bancamerica-Blair Corporation for $284,787.50.[223] The total number of shares purchased by the investment company from Bancamerica-Blair Corporation totaled 41,850 shares for an aggregate price of $1,340,575, or an average cost of $32.03 per share. The largest purchase occurred on May 13, 1931,

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[213] Id., at 673.
[214] Id., Commission's Exhibit No. 91.
[215] Id., at 679.
[216] Id., Commission's Exhibit No. 91.
[217] Id., at 675.
[218] Id., at 678.
[219] Id., Commission's Exhibit No. 15.
[220] Ibid.
[221] Id., Commission's Exhibit No. 7.
[222] Id., at 35.
[223] Id., Commission's Exhibit No. 7.

when Interstate Equities Corporation bought a block of 30,000 shares of its preferred stock from its sponsor for $855,000.[224]

Within three months thereafter Interstate Equities Corporation began repurchasing its preferred stock in the open market at $10 per share.[225] Mr. Tinker denied that Bancamerica-Blair Corporation caused Interstate Equities Corporation to repurchase its preferred stock from its sponsor and so bail out of its long position in a declining market.[226] However, it is significant that the last repurchase from Bancamerica-Blair Corporation on May 13, 1931,[227] aggregated 30,000 shares for a total of $855,000, and it is questionable whether the market would have been able to absorb these 30,000 shares at $28.50 per share.[228] Although Mr. Tinker admitted that the directorates of Bancamerica-Blair Corporation and Interstate Equities Corporation were interlocking, he did not perceive any conflict of interests engendered by this situation.[229]

2. REPURCHASES FROM INSIDERS AT PRICES ABOVE ASSET VALUE

As has been indicated, in those instances where investment companies repurchased their outstanding securities from insiders at below asset values, the insiders or managements justified these reacquisitions upon the grounds that the investment companies realized a profit on such repurchases—the difference between the asset values and purchase prices—or were supplying a more orderly market in rapidly declining markets to their investors who were compelled to engage in distress selling. However, no such justification could be urged for repurchases of outstanding shares at premiums—repurchases at prices above asset values. Such repurchases involved the expenditure of a greater amount of assets than was represented by the shares acquired and reduced the asset value of the remaining shares.[230]

The number of stockholders who could take advantage of a program of repurchase of outstanding securities at prices above asset value by a closed-end management investment company was limited by reason of the accelerated drain upon the investment fund. Furthermore, usually only the insiders who possessed advance notice of these repurchase plans could benefit from such operations. Various instances of reacquisitions of outstanding securities by investment companies at premiums either in the open market or by direct nego-

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224 Ibid.

225 Ibid.

226 Id., at 39.

227 Id., Commission's Exhibit No. 7.

228 Ibid.

229 Id., at 40–2.

230 Such repurchases could theoretically be made to the extent of expending all the resources of the investment company in acquiring part of its outstanding stock, and the remaining stockholders would hold an interest in a corporation possessing assets consisting only of its own shares. While statutes prohibiting the repurchase of security issues from other than surplus are not uncommon (e. g., sec. 664 of the Penal Law of New York [Consol. Laws, c. 40]; Gen'l. Corp. Laws of Delaware. Revised Code of 1935, Art. 1, sec. 19), it has been held in other jurisdictions that repurchased securities retained as treasury stock do not serve to reduce the capital stock to the prejudice of creditors (See *Scriggins* v. *Thomas Dalby Co.,* 290 Mass. 414, 195 N. E. 749, 1935). For a discussion of this problem, see Fletcher, Cyc. of the Law of Private Corps., Vol. II, Ch. 58, sec. 5148.

tiation were developed during the course of the study.[231] Such repurchases by investment trusts and investment companies afforded insiders the opportunity of selling their shares at prices which diluted the holdings of remaining shareholders—shareholders to whom such insiders frequently stood in some fiduciary capacity.

Liberty Share Corporation

Liberty Share Corporation is illustrative of the practices of trading by insiders in the securities of the investment companies during market supporting operations conducted by the investment company and by direct sales to the investment company, sometimes at prices above asset value.

Liberty Share Corporation was formed on April 2, 1929, as a consolidation of three predecessor companies, Liberty Bond and Share Corporation (investment affiliate of the Liberty Bank of Buffalo), Frontier National Corporation (investment affiliate of the Frontier National Bank of Buffalo), and North American Investors Corporation.[232] The corporation, which became a member of the Buffalo Stock Exchange, was organized to underwrite, buy, and sell securities and to conduct a general brokerage business.[233] The original capital of the investment company was $9,718,036, of which $3,195,174 was received from the predecessor companies through exchanges and the balance of $6,522,862 was received from the stockholders of the predecessor companies by the exercise of stock subscription rights.[234] Additional acquisitions in February 1930 increased the paid-in capital to $9,910,800.[235] However, as of September 30, 1936, the net worth of the investment company was only $710,000.[236] A substantial part of this decrease in assets resulted from repurchases of the investment company's capital stock.

Liberty Share Corporation raised its capital by issuing common stock at prices ranging from $13.73 to $30 a share, the latter amount being the price received under stock subscription rights.[237] By September 1929 the stock was selling at prices in excess of $100 a share,[238] but during the entire period the net asset value never exceeded $35 a share.[239] Nevertheless, the investment company undertook to engage in trading operations in its own shares and at the end of 1929 had expended the net sum of $3,451,429 for 51,788 shares at an average cost of $66.[240] Leon G. Ruth, president of Liberty Share Corporation, when examined as to these repurchases, testified:[241]

Q. What justification is there for repurchasing your own stock at a higher price than its asset value?

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[231] Over-all statistics upon the extent of such repurchases were not available.

[232] Reply to the Commission's questionnaire for Liberty Share Corporation, Pt. I.

[233] Public Examination, Liberty Share Corporation, at 8913, 8941.

[234] Op. cit. supra, note 232, Pt. II (Schedules 18 and 19).

[235] Ibid. Exchanges for stock of Great Lakes Share Corporation and Erie Share Corporation.

[236] Op. cit. supra, note 233, at 8898.

[237] Op. cit. supra, note 232, Pt. V (Item 40).

[238] Op. cit. supra, note 233, Commission's Exhibit No. 886.

[239] Id., at 9153.

[240] Op. cit. supra, note 232, Pt. V. The difference between these figures and the figures contained in Table 11, infra (derived from Commission's Exhibits Nos. 886, 887) was unexplained.

[241] Op. cit. supra, note 233, at 9153–6.

A. The only justification that I can give you is the fact that if we can take ourselves back for a moment to the psychology of 1929, I believe that by comparison it will be indicated most companies of similar character—the stocks of most companies of similar character were selling from two to three times their asset value.

I think that it was often expressed that companies of that character were entitled to sell at between two and three times their asset value.

Q. But when you buy your own stock, it is different from buying somebody else's stock.

A. I appreciate that.

* * * * * * *

Q. You have heard of cases where repurchases have been made below the asset value, because that increases the value of the remaining shares?

A. That is right.

* * * * * * *

Q. So that a repurchase of this sort, above the asset value, at double the asset value, decreases the value of the remaining shares.

A. That is correct.

Q. So that it really becomes a pure speculation, doesn't it?

A. That is correct.

These trading operations by Liberty Share Corporation resulted in an accumulation of its own securities at an average premium of 100%—acquisition of its own securities at an average price which was double the asset value of those securities. In effect, the sponsors caused the investment company to pay the premium of 100%, at which the public presumably appraised the management. These repurchases unquestionably provided market support for the capital stock of the investment company, of which the officers, directors, and other insiders took advantage when they disposed of their holdings. During the months of September through December 1929, when the investment company was most active in the market for its shares,[242] the officers and directors also actively traded in such shares and almost invariably sold their shares on balance—sold more shares than they purchased, thereby reducing, or entirely liquidating, their holdings of the investment company stock.[243] Not only did these insiders dispose of part of their holdings by their sales on balance in the open market, but they also sold substantial amounts to the investment company by direct transactions with the investment company. Thus, on October 4, 1929, the investment company bought 4,406 shares of its own stock from Jacob G. Lang, one of the original directors.[244] Evidently, in recognition of its large size, the purchase was consummated at a price from three to four points below the "prevailing" market, as indicated by the other transactions of the investment company on the same day.[245] Many other direct repurchases by the investment company of its own stock from insiders were disclosed. Direct repurchases from officers and directors at prices above asset

[242] Id., Commission's Exhibits Nos. 886, 887.

[243] Id., Commission's Exhibits No. 888.

[244] Id., Commission's Exhibit No. 886.

[245] Ibid. If it be assumed that Mr. Lang paid the highest original cost of $30 a share for this block of stock, the sale price of $80 a share netted him a profit of $220,300 on the transaction.

value accounted for 62% of total repurchases by the investment company of its own securities during December 1929.[246]

Table 11 shows the total acquisitions and sales by Liberty Share Corporation of its own securities during September 1929 through December 1930.[247]

TABLE 11.—*Acquisitions and resales of own securities by Liberty Share Corporation, September 1929–December 1930*

Period	Repurchases [a]		Resales	
	Number of shares	Price range	Number of shares	Price range
1929				
September	15,428	$80 -$107	7,751	$80¼-$105
October	44,362	52 - 85	15,209	53 - 88
November	13,082	25 - 63	8,608	25⅞- 64¼
December	13,431	34¼- 45	1,380	35 - 61.40
	86,303		32,948	
1930				
January	1,858	33 - 36½	10,165	33½- 37¼
February	2,199	32⅞- 41	4,222	33 - 41½
March	2,907	39 - 49	6,960	33.83- 49¾
April	5,576	49¼- 51½	5,813	49¾- 52
May	4,852	41½- 49⅝	3,426	41¾- 52
June	4,392	33½- 45	2,997	33¾- 45⅜
July	1,817	32⅝- 34¾	2,527	33¼- 35½
August	1,635	29 - 33¼	1,696	29 - 35½
September	20	30 - 30	54	29 - 31
October	[b] 2,401	19 - 26	166	23 - 28½
November	[b] 533	19 - 21⅞	12	21½- 24
December	116	15 - 19	3	21½- 23
	28,306		37,806	
Period	114,609 shares acquired.		70,754 shares sold.	

[a] These figures include stock dividends.
[b] Acquired substantially by single transaction.

This table discloses that substantial trading was conducted by the investment company until September 1930 by which time it had acquired a total of 111,539 of its own shares and resold a total of 70,521 shares. The investment company's trading in its own shares in 1930 constituted the major part of the market activity in the stock. For the months of June, July, and August, 1930, the total repurchases and resales by the investment company exceeded 75% of the total volume of trading in the shares on the Buffalo Stock Exchange.[248] In 1930 Liberty Share Corporation succeeded in reducing its net holdings by over 9,000 shares and in 1934 it held a balance of 39,785 shares at a net cost of $2,924,615.[249] When these holdings were retired in the latter year only $87,615 was chargeable to capital and

[246] Ibid. The largest part of this stock was taken back by the officers and directors during January and February 1930 (id., Commission's Exhibit No. 887).
[247] Op. cit. supra, note 205, Commission's Exhibits Nos. 886, 887.
[248] Id., Commission's Exhibit No. 889.
[249] Op. cit. supra, note 232, Pt. V.

surplus.[250] Thus the original capital received through sales and exchanges of securities in 1929 and 1930 was reduced by nearly 30% by these repurchases.

During 1930 insiders still traded in these shares upon the market or directly sold shares to the investment company. These insiders were interested in having the market maintained for the purposes of selling the shares thereof as well as maintaining the collateral value of their holdings which had been hypothecated in margin accounts in these shares.[251] It was during 1929, however, that the directors received the premiums over asset value when the investment company repurchased its own securities from these insiders.[252]

3. REPURCHASES FROM INSIDERS AT PAR OR ASSET VALUES

In some instances, closed-end investment companies repurchased their own securities from insiders at asset value or par value, while other shareholders were relegated to the open market to dispose of their securities.

General American Investors Company, Inc.

In the case of General American Investors Company, Inc., organized January 25, 1927, the subscribed capital originally consisted of $9,300,000, represented by a $7,500,000 depenture issue, sold to the public at par with 75,000 nondetachable common shares, and a $1,500,000 preferred stock issue, sold to the sponsors, Lazard Frères and Lehman Brothers, with 125,000 common shares for $1,800,000. The underwriting commission on the debenture issue was $225,000. After organization, the asset value of the common stock continued to rise by reason of appreciation in the market value of the portfolio securities.[253]

On May 28, 1929, the investment company retired the preferred stock and offered publicly additional common stock to provide a common stock backing for the debentures. These sponsors received from the investment company $1,500,000 in cash for their 15,000 preferred shares then held, an amount equivalent to the par value of the

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[250] Ibid. The remaining loss had been written off in prior periods.

[251] Op. cit. supra, note 233, at 9175–6. About 83 of the officers and directors of the Liberty Share Corporation and of the Liberty Bank of Buffalo had margin accounts with the investment company (id., at 8977). A syndicate formed by nine directors of the Liberty Share Corporation for the acquisition of stock of the investment company as well as other stocks terminated unsuccessfully. Two of the directors failed to cover their participations, and as a result the investment company, which had financed these operations by bank loans which the banking laws prohibited the participants from making either directly or indirectly (id., at 8965 and Commission's Exhibit Nos. 873, 874) found itself an ultimate participant to the extent of some $600,000 (id., at 8954–65). Liberty Share Corporation never disclosed these trading operations in its capital stock in the reports to its stockholders (id., at 9032–3) while the annual report for 1930 appraised these and other investments at prices exceeding market quotations by a write-up of approximately $4,000,000 (id., at 9008–10). The report of the New York State bank examiner condemned this statement as "very misleading" and its publication as "extremely reprehensible" and estimated the company's losses on margin accounts and depreciation at $1,800,000 (ibid., and Commission's Exhibit No. 878).

[252] See supra.

[253] For further details see supra, pp. 950 et seq.

stock.[254] Repurchases of preferred stock by the investment company would necessarily have to be made from the sponsors directly. Since the preferred stock was not dealt in on the open market quoted prices are not available for these preferred shares. However, the price at which these shares were repurchased can be compared with the market price at which the company's debentures—securities which had been issued simultaneously with the preferred stock and were senior thereto—were selling on the market. During May 1929, the market prices for the debentures ranged from 84¼–83, representing a discount from the face amount at the time the repurchase of the preferred stock was made at par. This repurchase of preferred stock from the sponsors in 1929 may be contrasted with subsequent repurchases from the public during the years 1930 through 1933 when the investment company acquired upon the open market for retirement 20,000 preferred shares [255] and $900,000 face amount of debentures at a total discount of approximately $700,000.[256]

Old Colony Investment Trust

A similar repurchase of preferred stock from insiders was made by Old Colony Investment Trust, organized on January 14, 1927, by Old Colony Corporation, the security affiliate of Old Colony Trust Company.[257] The capital of this investment company consisted of a $5,000,000 face amount noncallable debenture issue, which was distributed to the public with 50,000 shares of common stock for $4,975,000 [258] and 10,000 shares of preferred stock sold to Old Colony Corporation with 50,000 shares of common stock for $1,200,000.[259] Thus, the sponsor obtained 50,000 shares of common stock for an investment of $1,200,000 in the preferred stock, whereas the public received the remaining 50,000 shares with its investment of $5,000,000 in the debentures. Payment for this preferred stock was not made in cash but by the creation of a credit in favor of the investment company in the amount of the purchase price with Old Colony Trust Company.[260]

In anticipation of another debenture issue it was determined to retire the preferred stock and to issue additional common stock so that the cushion for the debentures would consist of a common stock backing.[261] Accordingly, the preferred stock held by the sponsor,

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[254] Reply to the Commission's questionnaire for General American Investors Company, Inc., Pt. V (Item 54, Table 17).

[255] This preferred stock had been issued by Second General American Investors Company, Inc., which was merged with the first company on September 5, 1929. These preferred shares were redeemable at $105.

[256] Op. cit. supra, note 254, Pt. V. This discount was computed upon the original par value of the preferred stock of $100.

[257] Public Examination, Old Colony Investment Trust, at 6109–11.

[258] Id., at 6125 and Commission's Exhibit No. 552. This debenture issue was unsecured and had no provision for acceleration of maturity upon default (id., at 6115–9).

[259] Op. cit. supra, note 257, at 6124–5. The preferred stock had a par of $100 and was callable at $120 per share (ibid.).

[260] Id., at 6135. As this account drew only 2% interest it was transferred to Old Colony Corporation at 5% interest. However, as the preferred stock was intended to pay dividends of 6% per annum the investment trust stood to lose at the rate of 1% per annum during the period that the money remained uninvested.

[261] Op. cit. supra, note 257, at 6127–9.

Old Colony Corporation, was called or repurchased by the investment trust for $1,200,000—the price which the sponsor paid for this block of preferred in combination with half of the outstanding common stock. As a consequence the sponsor received back its cash investment and still retained one-half of the outstanding common stock. Additional junior capital of $4,000,000 was thereupon raised by rights given to all common-stock holders (including the sponsors) to purchase two new common shares at $20 a share for each old common share held and the sponsor and the public contributed an additional $2,000,000 each. The sponsor therefore retained a 50% interest in the entire equity issue, as increased by $2,000,000 of public money, with the proceeds received by the sponsor on the preferred stock resold to the investment company and an additional investment of only $800,000.[262] An additional $2,500,000 principal amount of debentures was thereupon sold to the public, without any equity participation, for $2,425,000.[263]

Thereafter the investment company repurchased its outstanding debentures held by the public at the market discounts prevalent after 1930. During the period to February 1, 1937, $4,152,900 principal amount of debentures—more than half of the debentures issued—were repurchased by the investment company at a net cost of $3,387,603.[264]

D. Repurchases to Remove Opposition to Management

The poor performance records and large discounts at which the securities of many closed-end management investment trusts and investment companies were selling encouraged a series of operations whereby control of these investment companies was to be acquired by new interests.[265] While in many instances, management groups were anxious to sever their relations with investment companies, in other cases efforts to obtain control of such organizations met with active opposition by incumbent managements. Although the existing management was usually safe against deposition by proxy fights, the insiders would sometimes eliminate opposition groups or persons desiring to obtain control by causing the investment company to purchase the opposition's holdings of the investment companies' securities.

Oils & Industries, Inc.

This method was employed by Arthur S. Kleeman to retain control over Oils & Industries, Inc., formerly known as Oil Shares, Inc.[266] On May 16, 1932, Mr. Kleeman, the president and largest stockholder of Home & Foreign Securities Corporation, another investment company, took over the management of Oils & Industries, Inc. On Au-

[262] Ibid.

[263] Id., at 6129, and Commission's Exhibit No. 553.

[264] Reply to the Commission's questionnaire for Old Colony Investment Trust, Pt. II (Exhibit A, Schedule 16), and derived from supplementary information supplied the Commission for Old Colony Investment Trust. The greatest part of these repurchases was made in the year ending February 1, 1937, when $1,450,300 face amount of debentures were acquired at a net discount of only $1,758 (ibid.).

[265] See Ch. IV of this part of the report.

[266] For full details, see Ch. II of this part of the report, pp. 94–115.

gust 15, 1933, Oils & Industries, Inc., was recapitalized so that only one class of stock was outstanding—stock which the company had to redeem at 91% of asset value, if tendered in 500-share lots. This redemption right was subsequently restricted to 1,000-share lots to be redeemed at 95% of asset value.

At the instance of Mr. Kleeman, who apparently was desirous of cementing his position, David Milton, president of The Equity Corporation, became, through Group Assets, Inc., the holder of the largest block of the stock of Oils & Industries, Inc., controlling approximately 40% of the voting strength. However, Mr. Milton soon apprised Mr. Kleeman of his plan to make an exchange offer to the remaining shareholders of Oils & Industries, Inc., with the ultimate expectation of taking over control of that investment company. Mr. Kleeman forestalled this move by threatening to advise other stockholders to redeem their shares and thereby diminish the size of the company. On June 8, 1934, Mr. Milton sold Home & Foreign Securities Corporation, the investment company controlled by Mr. Kleeman, 25,000 of these shares of Oils & Industries, Inc. for $535,000, an average price of $21.41 a share. The asset value at the time was $19.88 and no general market for these shares existed. As its total assets of Home & Foreign Securities Corporation at that time had declined to about $300,000, it had to borrow $360,000 from a bank to effect this purchase. Approximately $20,000 was raised by Home & Foreign Securities Corporation by the redemption of 1,000 shares of Oils & Industries, Inc., but apparently Mr. Kleeman did not wish further to impair his voting power by tendering any more of these shares for redemption.

On August 31, 1934, the stockholders of Oils & Industries, Inc., approved a recapitalization plan providing for the creation of non-voting preferred stock redeemable within three weeks after issue in 1,000-share lots at 95% of the liquidating value and providing for the termination of the redemption rights of the common shares. This preferred stock was thereupon issued as a stock dividend—one share of new preferred for each share of common stock. Few if any of the stockholders of Oils & Industries, Inc., other than Home & Foreign Securities Corporation, received sufficient preferred shares to be able to take advantage of the redemption right. Only Home & Foreign Securities availed itself of the redemption right and with the proceeds received thereby paid off the substantial balance of the bank loan. At the same time Mr. Kleeman retained common shares which constituted voting control over Oils & Industries, Inc.

Similarly, National Investors Corporation group was caused by the management to buy out the holdings of Atlas Corporation.

National Investors Corporation Group

On June 16, 1927 National Investors Corporation was formed by Fred Y. Presley and financed by Guardian Detroit Company, of Detroit, Michigan, a bank security affiliate. The investment company possessed original paid-in capital of $4,400,000 which was thereafter invested in the equity securities of a series of three subsidiary investment companies, known respectively as Second, Third, and Fourth

National Investors Corporations, organized in 1928 and 1929 with total paid-in capital of $48,000,000.[267 268]

In 1931, Floyd B. Odlum, president of Atlas Corporation, became interested in acquiring common shares of National Investors' Corporation,[269] and, although opposed by the incumbent management group who believed that Mr. Odlum intended to acquire control of the investment company and then make an offer to exchange Atlas Corporation shares for National Investors Corporation shares,[270] Atlas Corporation began to acquire the shares of National Investors Corporation in the open market.[271] In the late fall of 1931 Atlas Corporation had acquired some 75,000 shares of the common stock of National Investors' Corporation with a few thousand option warrants. Mr. Odlum then advised Mr. Presley that he would entertain a bid for the shares.[272] Such acquisitions continued and in 1933, at the time of the bank moratorium, a receiver was appointed for the Guardian Detroit Company, and that bank affiliate's holding of about 150,000 common shares of National Investors Corporation thereby also became available.[273] By this time Atlas Corporation owned about 160,000 common shares and 25,000 option warrants of National Investors Corporation and its acquisition of the shares held by the receiver of Guardian Detroit Company would have meant practical control of the investment company by Atlas Corporation.[274] In addition, Atlas Corporation held approximately 17,000 shares of the preferred stock of Second National Investors Corporation, out of 83,000 shares outstanding, and 52,000 common shares of Third National Investors Corporation, out of 220,000 shares outstanding, as well as a few shares of Fourth National Investors Corporation.[275]

The management of National Investors Corporation, apprehensive of losing control, made efforts to persuade the receiver of Guardian Detroit Company to refrain from selling the shares held by him to Atlas Corporation.[276] Failing in this effort, the management group was compelled to do business with Mr. Odlum who expressed a willingness to cooperate if Second and Third National Investors Corporations would repurchase his holdings at 90% of their asset values. At the same time he offered to sell his holdings of 160,000 shares of National Investors Corporation common stock at $125,000, which was below the asset and market values.[277] Up to this time, National Investors Corporation had never repurchased any of its outstanding securities even though they may have sold at discounts.[278] It was finally agreed that the acceptance of an offer by Atlas Corporation

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[267 268] See supra, pp. 887 et seq.

[269] Public Examination, National Investors Corporation, at 4518.

[270] Id., at 4519.

[271] Id., at 4521.

[272] Id., at 4522–3.

[273] Id., at 4525–6. About a third of these 150,000 shares consisted of collateral for loans which were under water (ibid.).

[274] Op. cit. supra, note 269, at 4529.

[275] Ibid.

[276] Id., at 4526.

[277] Id., at 4530, 4538–9.

[278] Id., at 4484–5.

to sell its 17,383 convertible prefered stocks of Second National Investors Corporation at $49.86, 80% of asset value, and its 52,724 shares of common stock of Third National Investors Corporation at $21.96, 90% of asset value, be submitted to the stockholders of the respective National Investors investment companies for approval. While the letters to stockholders dated May 24, 1933 disclosed that these prices were above the market quotations they did not indicate the actual spread of $3.23 to $5.36 a preferred share and $2.96 a common share.[279] This offer was approved except with respect to the holdings of Atlas Corporation of the common stock of National Investors Corporation, which were not sold back to that investment company. Mr. Presley testified:[280]

Q. Why didn't you buy that stock [common stock of National Investors Corporation]?

A. Well, I couldn't buy stock for the National below the market price, and as president of Second and Third recommend that they pay above the market.

Q. You felt that was an impossible bargain to put yourself in?

A. Exactly.

Q. Did you feel, on the other hand, that you were free to attempt to place that stock elsewhere.

A. Yes.

Q. Did you ask for time in which to do that?

A. Oh, no, because that whole arrangement was vitiated by the fact that I asked for a reduction in the price of Second preferred from 90 percent of asset value to 80 percent.

Q. So that knocked out the plan to offer you 165,000 [shares] at $125,000?

A. Yes.

Q. So, after you had [bought] the shares of Second and Third respectively, held [by Atlas Corporation], it [Atlas Corporation] still continued to hold the common and warrants of National Investors?

A. That is correct.

This common stock remained outstanding and apparently influenced the management group ultimately to effect the merger between National Investors Corporation and its three subsidiaries.[281]

E. Repurchases for Readjustment of Leverage and to Prevent "Touch-Off"

1. READJUSTMENT OF LEVERAGE

All capital appreciation of a leverage investment trust or investment company, whose senior issues were fully covered and whose fixed charges were earned, accrues to the benefit of the common stockholders. Conversely, depreciation in the value of the total assets of a leverage company, including losses upon assets purchased with the proceeds of senior securities, is first borne by the common stockholders. As a consequence, the asset value of the common stock rises or falls faster than the rise or fall respectively of the market

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[279] Replies to the Commission's questionnaire for Second and Third National Investors Corporations, Pt. V.

[280] Op. cit. supra, note 269, at 4539.

[281] See Ch. IV of this part of the report, pp. 1460–79.

value of the total assets of a leverage investment company.[282] Accordingly, during a rising security market a leverage investment company might consider it expedient to repurchase its outstanding common stocks in order to increase the leverage factor and during a declining market might repurchase its outstanding preferred stocks or bonds in order to decrease the leverage factor. However, the implications of repurchases of its own common stock by a leverage company are much more serious than in the case of its repurchases of its bonds and preferred stocks. When common stock is repurchased while bonds or preferred stock are outstanding the amount of the "cushion" below the senior securities is reduced; that is, there is a reduction in the junior money available for the protection of senior securities against further market declines, and a weakening of the capital structure. As was stated by the New York Stock Exchange:[283]

> The reacquisition of common shares would appear in most cases to be open to the objection that it would tend to reduce the equity in back of prior securities upon which the holders of these securities are justified in relying. Where common stock is reacquired for the purpose of prompt re-issue in connection with the acquisition of assets, this objection may lose its validity.

Repurchases of senior securities were especially potent in affecting the leverage when they could be made at discounts from asset or face values, as was usually possible during the declining markets following 1929.

The leverage structure of Atlas Corporation and its effect on the common stock apparently was an important factor in that company's program of acquiring other investment companies. During the period of declining security markets following 1929 the emphasis was upon reducing the leverage of the Atlas Corporation. However, instead of accomplishing the reduction of leverage by repurchases of senior securities the investment company adopted the technique of issuing additional blocks of its common stock to be used in exchange offers to security holders of other investment companies.[284]

With the return of favorable security markets steps were taken to increase the leverage structure of Atlas Corporation. In October 1936, Atlas Corporation concluded a merger with its subsidiaries, creating a total capital of approximately $100,659,000 of which 23% was applicable to the new preferred stock and 77% represented the common stock equity.[285] However, the policy of the management apparently was to maintain a leverage ratio of 40% preferred stocks

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[282] For a discussion of leverage see Pt. One of this report (House Doc. No. 707, 75th Cong.), Ch. II, pp. 28–9. See also Ch. I of this part of the report, pp. 12–13.

[283] Extract from Statement of the Committee on Stock List, New York Stock Exchange, concerning Investment Trusts, adopted April 22, 1931. As to the value of the "cushion" cf. 29 Columbia Law Review (1939); *Matter of Dresser,* 247 N. Y. 553 (1938); 52 Harvard Law Review 1331 (1939); dissenting opinion of Commissioner Frank *In the Matter of North American Company,* S. E. C. Holding Company Act Release No. 1427 (January 30, 1939).

[284] For details see Ch. IV of this part of the report. Thus, Atlas Corporation's net worth of $13,888,616 as at December 31, 1929, consisting of 64% of preference stock and 36% of common stock, increased to $76,830,697 as at June 30, 1936, consisting of 17% of preference stock and 83% of common stock (op. cit. supra, note 164, Commission's Exhibit No. 1943).

[285] Op. cit. supra, note 164, Commission's Exhibit No. 1944.

and 60% common stocks.[286] When this objective could not be accomplished by exchange programs of common shares of Atlas Corporation for new preferred shares of Atlas Corporation,[287] Atlas Corporation instituted a program of repurchasing its outstanding common shares.

As at January 31, 1937, the capital of Atlas Corporation increased to $107,536,303 of which 25% was represented by preferred stock and 75% was represented by common stock.[288] At that time 221,183 common shares were held in the treasury and the investment company announced that it would continue its repurchase policy.[289] As of April 30, 1938, the treasury holdings had increased to 742,605 common shares, leaving total net worth of $56,565,622,[290] represented 42% by preferred stock and 58% by common stock.[291]

Capital structures consisting largely of debts and preferred stocks were of concern to their managers during periods of severe market declines, not only by reason of the leverage factor but also because of the drain upon investment funds to meet the senior rights of such issues, as the fixed interest and dividend payments. This problem of preventing defaults in the bond issues of Standard Investing Corporation was recognized in the testimony of Ray Morris: [292]

> Q. * * * The management of Standard Investing Corporation had not been particularly successful, isn't that so?
>
> A. I think it is a fair statement. We certainly founded the trust at the wrong time and we were certainly handicapped in the feeling the necessity of selling stocks in the low markets, 1932, to protect our bonds.
>
> Q. I am curious about that. You said that you had to sell your stocks at the lower point of the market to protect your bonds; why was that?
>
> A. We didn't have to, but in 1932, at the low point there were certainly some weeks there when our bonds were not fully covered with assets, and you couldn't tell how much lower the market was going in those days, and the directors thought that they were protecting the bonds by selling stocks and holding cash or buying Government bonds or something of the sort, as a coverage for the bonds, because they thought that the assets might continue to shrink to a point where default on the bonds would be brought about.

Tri-Continental Corporation met its problems of this character by conducting a program of reacquiring its 5% preferred stock from April to September 1936 by the repurchase of 16,121 shares and the redemption by call of 90,000 shares (at the call price of $110 a share).[293] Bank loans totaling $10,000,000 were negotiated with the Central Hanover Bank and Guaranty Trust Company, bearing interest of from 2% to 3½% per annum over a five-year period,[294] to finance this recapitalization. The purposes of retiring such a large block of preferred stock included the desire to cut down the high rate

[286] Id., Commission's Exhibit No. 1943 (report of January 31, 1937).

[287] Ibid.

[288] Ibid.

[289] Ibid.

[290] This decrease was due primarily to market declines.

[291] Derived from supplementary information supplied the Commission for Atlas Corporation.

[292] Op. cit. supra, note 181, at 15243.

[293] Derived from supplementary information supplied the Commission for Tri-Continental Corporation.

[294] Tri-Continental Corporation could pay off the loan at any time at its option (ibid.).

of senior charges, to improve the common dividend position, and to substitute short-term loans for long-term senior capital.

2. PREVENTING THE OPERATION OF "TOUCH-OFF" CLAUSES IN DEBENTURES

The capital structures of closed-end management investment trusts and investment companies sometimes included debenture issues, which required that a specified ratio be maintained between the assets of the investment company and the principal amount of its debentures outstanding. When such provisions were contained in the indenture agreements they usually required an asset coverage of 125% or 150%—that is, the investment company was required to have $125 or $150 (depending upon the provision) for every $100 of principal amount of debentures outstanding. These provisions are known as the "touch-off" clause, for in the event that the prescribed asset coverage was not maintained, an event of default could usually be declared and the maturities of the debentures accelerated. This impending operation of the "touch-off" clause of the indenture agreement, could sometimes be forestalled by repurchases of the debentures, particularly if these obligations could be reacquired at discounts—at market prices below the face or principal amount of the debentures. By such reacquisitions the aggregate principal amount of the outstanding debentures of the investment company was reduced and the amount of total assets required was more greatly reduced. The percentage of asset coverage of an outstanding debenture issue could thereby be increased above the level provided in the "touch-off" clause.[295]

The amount of debentures to be repurchased in a measure depended upon the spread between the purchase price and the required asset coverage. Accordingly, repurchases at discounts from face or maturity values hastened the attainment of the desired asset coverage. This operation was, in effect, a specialized form of leverage readjustment.

Eastern Utilities Investing Corporation

While the foregoing device to prevent the operation of the "touch-off" clause ordinarily involved the direct repurchase of the debentures and their subsequent retirement, the same result was obtained by a somewhat different technique employed in the case of Eastern Utilities Investing Corporation. This company was incorporated in August 1922 and became an investment company in July 1927 when it assumed its present name.[296] In July 1925 Associated Gas and Electric Company purchased control of the company from H. D. Walbridge & Co., Inc., the original sponsor, and has since dominated and controlled its policies.

Among the securities issued by Eastern Utilities Investing Corporation was a $35,000,000 debenture issue offered through Harris, Forbes & Company and Halsey, Stuart & Company in March 1929. One of the protective provisions for these debentures was a "touch-off" clause in the trust indenture by which the investment company covenanted

[295] For a further discussion of repurchases to prevent the operation of "touch-off" clauses, see Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 237–8.

[296] For further details see Ch. II of this part of the report, pp. 624–775.

that it would maintain at all times a ratio of assets to funded debt of at least 125% [297] and that if at any time this ratio should fall below 125%, the trustee, the New York Trust Company, might declare the debentures to be in default and take steps to enforce the rights of the holders.[298] However, the trustee was not required to take any action if asset coverage fell below 125% unless the holders of at least 15% of the face amount of the outstanding debentures affirmatively demanded that it do so.[299]

In 1931, with the general shrinkage in security values, the asset coverage for the outstanding debentures of Eastern Utilities Investing Corporation fell close to the "touch-off" point.[300] Accordingly, in June 1931, Associated Gas and Electric Company through several of its subsidiaries, particularly Associated Gas and Electric Securities Company and General Finance Corporation, began a series of exchange offers to the holders of the securities of Eastern Utilities Investing Corporation, and particularly the debenture holders, designed to switch them into the security issues of other companies of the system. Since the assets could not be increased nor the market decline arrested, "the only other possible solution was to decrease the amount of outstanding indebtedness in a greater ratio than a decrease in assets, in order to retire that indebtedness." [301]

The intensity of the program to reacquire the debentures of Eastern Utilities Investing Corporation is revealed by the fact that from June 1931 to the end of 1935, at least 20 different offers of exchange were sent to the debenture holders and during the last half of 1931 Associated Gas and Electric Securities Company sent six different offering letters. By December 1931, $18,494,000 of the $35,000,000 principal amount of debentures of Eastern Utilities Investing Corporation originally issued had been reacquired by Associated Utilities Investing Corporation.[302] These debentures were sold to Eastern Utilities Investing Corporation at par.[303] However, these were not directly transferred to the issuing company, but to Southern Utilities General Corporation, an inactive company which was made a subsidiary of Eastern Utilities Investing Corporation so that it might act as a receptacle for the reacquired debentures.

On April 12, 1932 Utility Accountants and Tax Consultants [304] issued a certificate showing that Eastern Utilities Investing Corporation had outstanding only $16,506,000 of principal amount of debentures.[305] For the purposes of determining whether the requisite asset coverage for the debentures was maintained, the reacquired debentures held by Southern Utilities General Corporation were treated

[297] Public Examination, Eastern Utilities Investing Corporation, Commission's Exhibit No. 3771 (Pt. I, Article III, Sec. 14).

[298] Id., Commission's Exhibit No. 3771 (Article VI, Sec. 2).

[299] Ibid.

[300] The investment company itself admitted this to be the case in November 1931, when it urged this as an inducement to its preferred stockholders under an exchange offer made at the time (id., Commission's Exhibit No. 3772, Item 40).

[301] Testimony of Mr. Stix (in the United States District Court for the District of Delaware, *In the Matter of Eastern Utilities Investing Corporation*, Debtor, No. 1247, in Reorganization Tax Proceedings before William Pickett as Special Master, pp. 125, 127–34).

[302] Op. cit. supra, note 297, Commission's Exhibit No. 3772 (Item 19).

[303] Id., at 25993–4.

[304] A service company sponsored by H. C. Hopson.

[305] Op. cit. supra, note 297, Commission's Exhibit No. 3782 (Item 42).

as retired. Based on this alleged amount of debt, the ratio of asset coverage was more than 150%.[306]

With further declines in assets during 1932, the reacquisition program by exchange offers was vigorously continued. However, in June 1932 the trustee notified the investment company of its default in asset coverage on the basis of $35,000,000 in debentures outstanding.[307] Accordingly, the reacquisition program now served the purpose of mustering enough of the debentures to vote an amendment to the trust indenture which would abrogate the "touch-off" clause. Such an amendment of the trust indenture required a vote of 85% of the outstanding debentures. By February 1933, of the $35,000,000 originally issued, only $6,135,000 was still outstanding with the public, while $18,975,000 of debentures was held by Southern Utilities General Corporation, the wholly-owned subsidiary of Eastern Utilities Investing Corporation, and $10,070,000 of debentures was held by Associated Gas and Electric Company and its subsidiaries. The system, therefore, was just short of the required 85%. If the entire $35,000,000 was to be considered as outstanding, the system held 82.5%. If, however, the $18,795,000 held by the issuing company's subsidiary was to be disqualified from voting on the ground that it was not outstanding, then the system held only 62%.

At this point, the investment company urged the trustee to call a meeting of debenture holders for the purpose of amending the indenture to eliminate all provisions giving the trustee or debenture holders the right to declare a default for any reason except nonpayment of principal or interest.[308] A meeting was called for June 21, 1933, when the system had assured itself of control of an adequate number of votes to pass the amendment regardless of whether the $18,795,000 held by the issuing company's subsidiary would be considered as outstanding debentures, and the amendments were adopted.[309]

International Securities Corporation of America, Second International Securities Corporation, and United States & British International Company, Ltd.

The trustee and holders of debentures issued by International Securities Corporation of America, Second International Securities Corporation and United States & British International Company, Ltd., all companies in the United Founders Corporation group of investment companies, were apparently satisfied to permit the violation of the provisions of the trust indentures as to asset coverage while the investment companies engaged in repurchases which, in two cases, did not serve entirely to correct the asset deficiencies. International Securities Corporation of America was incorporated in June 1927

[306] The books of The New York Trust Company, the trustee, reflected $35,000,000 of principal amount of debentures as still outstanding (id., at 23801).

[307] Op. cit. supra, note 279, at 23821–3 and Commission's Exhibit No. 3782 (Item 58).

[308] Id., at 23852–7 and Commission's Exhibit No. 3782 (Item 94).

[309] Upon protest at the meeting, this $18,795,000 was disqualified from voting. Debentures held by other system companies were allowed to vote, however, and the amendments were accordingly made by a vote of a fraction above 85% (id., at 23884–5). It was figured that $13,774,250 in principal amount constituted 85% of those entitled to vote. The actual vote in favor of the amendments was $13,803,000 in principal amount or slightly in excess of 85% (ibid.).

after having been operated as a trust,[310] Second International Securities Corporation was organized in October 1926,[311] and United States & British International Company, Ltd., was formed in January 1928.[312] These three companies were subsidiaries of American Founders Corporation which in turn was controlled by United Founders Corporation.[313] Each of these investment companies had common stock, preferred stock and debentures outstanding at the end of 1929. At that time International Securities Corporation of America possessed assets of some $71,500,000, including proceeds from $32,-000,000 face amount of debentures,[314] Second International Securities Corporation possessed assets of some $26,000,000, including proceeds from $7,000,000 face amount of debentures,[315] and United States & British International Company, Ltd., had assets of approximately $18,000,000, including proceeds from $6,000,000 face amount of debentures.[316] All of these debenture issues had been distributed by Harris Forbes & Company.[317]

One of the provisions of the trust indentures under which the debentures distributed by Harris Forbes & Company were issued was that the respective issuing investment companies would maintain at all times assets of a fair (market, if available) value of 125% of the face amount of debentures outstanding.[318] It was further provided that, in the event this coverage was not maintained, the trustee in the particular case might in its discretion, and, upon demand of a prescribed percentage of debenture holders in interest, was under obligation to serve notice of default on the debtor company and demand payment of the face amount of the debentures.[319] Harris Forbes & Company, as distributor of the debentures, was given representation, in the persons of E. C. Granbery and D. C. Wheaton, on the boards of the various investment companies, as a protection for the interests of the debenture holders, particularly with respect to the maintenance of the required 125% asset coverage.[320]

In 1931 the assets of both International Securities Corporation and United States & British International Company, Ltd., fell below the 125% coverage requirement for debentures outstanding and the following year there was a similar deficiency in the asset coverage for Second International Securities Corporation. The investment companies thereupon entered upon a program of repurchasing their outstanding debentures at discount prices for retirement, in order "to

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[310] Public Examination, American General Corporation, et al., Commission's Exhibit No. 3401 (G–1).

[311] Id., Commission's Exhibit No. 3406 (1).

[312] Id., Commission's Exhibit No. 3408 (1).

[313] Id., at 22101, 24768–74, and Commission's Exhibits Nos. 3420 (E–4), 3729, 3731, and 3733.

[314] Id., Commission's Exhibit No. 3402 (p. 169).

[315] Id., Commission's Exhibit No. 3407 (p. 6).

[316] Id., Commission's Exhibit No. 3409 (p. 6).

[317] In addition, there were outstanding at the end of November 1929 about $900,000 secured bonds assumed by International Securities Corporation of America, representing the residue of $8,000,000 of such bonds issued by its predecessor trust (id., Commission's Exhibits Nos. 3400 (p. 6) and 3402 (p. 6)).

[318] Id., Commission's Exhibits Nos. 3401–D, 3406–D, and 3408–D.

[319] Ibid.

[320] Id., at 25318–20.

build up the asset value to try to insure it and bring it back to 125%." [321]

International Securities Corporation was the heaviest repurchaser of its own debentures, as indicated by Table 12: [322]

TABLE 12.—*Repurchases and retirement of 5% debentures of International Securities Corporation of America*

6 months ending—	Face amount	Cost of acquisition	Average cost per unit	Discount	Asset coverage
					Percent
Nov. 30, 1930	$483,000	$381,084	$79	$101,916	----------
May 31, 1931	1,195,000	885,184	74	309,816	142
Nov. 30, 1931	2,918,000	1,779,992	61	1,138,008	105
May 31, 1932	12,571,000	6,703,732	53	5,867,268	77
Nov. 30, 1932	113,000	46,096	41	66,904	97
May 31, 1933	119,000	49,787	42	69,213	110
Nov. 30, 1933	----------	----------	----------	----------	101
May 31, 1934	11,000	5,005	46	5,995	113

It is interesting to observe that the asset coverage fell below the "touch-off" point toward the end of 1931 and that throughout most of 1932 the asset coverage was substantially below even the face amount of the debentures outstanding. It was during 1932 that over 70% of the repurchases were made, with but nominal repurchases thereafter, although the debentures had not reached the required 125% coverage by the end of May 1935. [323]

The asset coverage for the debentures of Second International Securities Corporation fell below 125% only in 1932, when the principal repurchases were effected, and never fell below the face amount of the debentures outstanding. Repurchases were effected primarily in 1932, as indicated by Table 13: [324]

TABLE 13.—*Repurchases and retirement of 5% debentures of Second International Securities Corporation*

6 months ending—	Face amount	Cost of acquisition	Average cost per unit	Discount	Asset coverage
					Percent
Nov. 30, 1930	$100,000	$80,140	$80	$19,860	----------
May 31, 1931	196,000	147,608	75	48,392	207
Nov. 30, 1931	199,000	127,070	64	71,930	146
May 31, 1932	2,569,000	1,358,755	53	1,210,245	104
Nov. 30, 1932	161,000	76,171	47	84,829	131

Finally the assets of United States & British International Company, Ltd., fell below the 125% coverage in the latter part of 1931, were below the face amount of outstanding debentures in 1932, and

[321] Id., at 25327–28.
[322] Compiled from information contained in id., Commission's Exhibit No. 3402 (p. 169).
[323] Op. cit. supra, note 310, Commission's Exhibit No. 3401 (F–14).
[324] Compiled from information contained in id., Commission's Exhibit No. 3407 (p. 122).

had not recovered to 125% coverage at the end of May 1935.[325] Repurchases were heaviest during 1932 when asset coverage was below the face amount of debentures, accounting for about 77% of all repurchases, and practically ceased thereafter, as indicated by Table 14:[326]

TABLE 14.—*Repurchases and retirement of 5% debentures of United States & British International Company, Ltd.*

6 months ending—	Face amount	Cost of acquisition	Average cost per unit	Discount	Asset coverage
					Percent
Nov. 30, 1930	$149,000	$117,755	$79	$31,245	----------
May 31, 1931	159,500	118,080	74	41,420	166
Nov. 30, 1931	425,500	297,195	70	128,305	112
May 31, 1932	2,615,500	1,406,092	54	1,209,408	92
Nov. 30, 1932	94,000	40,920	44	53,080	101
May 31, 1933	70,500	31,062	44	39,438	112

Over the 1930–1934 period these three investment companies repurchased an aggregate of $24,149,000 face amount of their debentures at a cost of $13,651,728. Heaviest repurchases by each company were in the early part of 1932 when, in two instances, the asset coverage was substantially below the face amounts of the outstanding debenture issues.

As will be recalled, the trustee appointed under the trust indentures could, in its discretion, have accelerated the payment of the debts represented by the debenture issues. Largely through the efforts of Mr. Granbery, who was elected to the boards of directors of these investment companies as a safeguard for the debenture holders, it was decided to be better management not to enforce the acceleration clause.[327] Had it been determined otherwise it was Mr. Granbery's opinion that Harris Forbes & Company was in a position to bring pressure on the trustee to act as well as to secure the cooperation of enough debenture holders to compel the trustee to act.[328]

However, Mr. Granbery never had the opportunity to exercise his unbiased judgment in this situation. During the period of these repurchases of debentures Mr. Granbery was a stockholder and director of both United Founders Corporation and American Founders Corporation.[329] It was accordingly contrary to his personal interests as a stockholder and in conflict with his duties as director of the parent companies to have effected liquidations which would have meant the sacrifice of the equity securities. This conflicting interest through the interlocking directorships was admitted by Mr. Granbery, as follows:[330]

Q. Your situation was that you were also a director of American Founders?

A. Yes, sir.

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[325] Op. cit. supra, note 310, Commission's Exhibit No. 3409 (F–13).

[326] Compiled from information contained in id., Commission's Exhibit No. 3409 (p. 96).

[327] Op. cit. supra, note 310, at 25320–1.

[328] Id., at 25324.

[329] Id., at 25324, 25333. Mr. Granbery held 10,000 shares of United Founders Corporation at a cost of about $80,000 in 1932 when the question of asset coverage was most pressing.

[330] Op. cit. supra, note 310, at 25324.

Q. And as well a director of the United Founders?

A. Yes, sir.

Q. And you represented the equity holders there?

A. Yes, sir.

Q. As well as representing Harris Forbes?

A. Yes, sir.

Q. Now, the interest of the equity holders, I suppose was not to have the debentures foreclosed?

A. Right.[331]

F. The Influence of Repurchases Upon Mergers, Consolidations, and Acquisitions

Repurchases of the securities of closed-end management investment trusts and investment companies played varied and important parts in mergers, consolidations, and acquisitions effected among these companies. For example, they provided a means for adjusting the capital structures of the investment companies involved, for removing opposition to the mergers, and even for manipulating the market values of the securities involved in the exchange offers.[332]

Tri-Continental Corporation

Thus, repurchases were employed to facilitate the merger of Tri-Continental Corporation and Tri-Continental Allied Co., Inc., two investment companies formed successively in 1929 under the sponsorship of J. & W. Seligman & Co., investment bankers and brokers.[333] Each company had received paid-in assets of $50,000,000, represented by preferred and common stock issues.[334] Each investment company also had outstanding a substantial quantity of long-term option warrants.[335]

On December 31, 1929, these two investment companies were merged to create a Tri-Continental Corporation possessing combined assets of $75,302,000.[336] To work out a plan for exchanging the preferred stocks of the two merging companies for shares of the preferred stock of the new company upon a share-for-share basis, it was considered desirable to build up the asset coverage of the preferred stock of Tri-Continental Allied Co., Inc., from 169% to the then 181% coverage of the original Tri-Continental Corporation.[337] Earle Bailie, chairman of the board of directors of Tri-Continental Corporation and a member of the sponsor firm, testified:[338]

Q. It was not necessary, was it, to buy $4,000,000 worth of preferred stock and sell it?

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[331] Mr. Granbery testified that to remedy such situations and to obviate any possibility that a person should have to serve two masters at the same time a person should be permitted to be a director of only one investment trust at a time (id., at 25334).

[332] For further discussion and examples see Ch. IV of this part of the report.

[333] Summary statement supplied the Commission for Tri-Continental Corporation and Tri-Continental Allied Co., Inc.

[334] Ibid.

[335] Ibid.

[336] Op. cit. supra, note 74, at 18, 551, and Commission's Exhibit No. 2080.

[337] Op. cit. supra, note 333 (Exhibits III, A, B).

[338] Op. cit. supra, note 74, at 18, 544–5.

A. The consolidation could not have gone through on a basis of equal treatment for Allied preferred unless the asset value behind the Allied preferred was roughly the equivalent of the asset value behind the old Tri-Continental preferred, because if you had not had that same asset value the old Tri-Continental would have been disadvantaged in getting into a company where its asset value would have been lowered by the consolidation.

Q. That was a question of equalizing the value of the senior securities?

A. That is right.

In connection with this merger plan J. & W. Seligman & Co. was to sell directly to Tri-Continental Allied Co., Inc. a block of 112,000 shares of the latter's preferred stock (with warrants attached) of $50 par value, at $37.50 a share and accrued dividends, for retirement.[339] This repurchase by the investment company, which was made below the prevailing market price,[340] of course provided J. & W. Seligman & Co. with over $4,100,000 of cash. The proposed repurchase from J. & W. Seligman & Co. was disclosed to stockholders of both investment companies in the letters dated December 11, 1929, soliciting their proxies for the approval of the plan of merger.[341] Mr. Bailie testified further as to this repurchase from J. & W. Seligman & Co.:[342]

Q. What I was asking is why they had to buy from Seligman instead of making a general offer to the other stockholders. Here is $4,000,000 in December 1929 retired when cash was pretty useful, wasn't it?

A. It certainly was to some people.

Q. What I am asking is why this repurchase of preferred stock should have been made solely from Seligman.

A. We knew nobody else who was willing to sell preferred stock at what I believed was ten points below the market. In order to make this transaction go through, if we had thought there were any such philanthropists about we would have gone to see them. You will realize that the situation was one where some of our partners were bitterly opposed to disposing of this stock at this price, feeling we were losing a very substantial amount of money when we had a preferred stock with an asset value of 150 which you were selling for 75, with a call price of 110. As it turned out, within four months it cost us $4,000,000 because the stock had gone up repeatedly in price. That is all hindsight. That is, as we looked at it at the time, we thought it was the proper thing to do. We told the stockholders and they thought it was the proper thing to do, and while something else might have been done that is what was done. Everybody approved of it and that is what was done.

* * * * * * *

Q. But you didn't make any solicitation of your stockholders?

A. I have never found it worth while looking for angels in this world, Mr. Smith.

Q. Are you implying that Seligman was an angel here?

A. I don't think so. I can see what you think, but I don't think that way. I feel that it is an honest difference of opinion.

Q. I am trying not to say what I am thinking.

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[339] Op. cit. supra, note 335, Exhibits III, A, B. J. & W. Seligman & Co. also surrendered a block of option warrants issued by Tri-Continental Corporation (ibid.).

[340] Op. cit. supra, note 74, at 18546.

[341] Op. cit. supra, note 333, Exhibits III, A, B.

[342] Op. cit. supra, note 74, at 18545–7.

A. What you would like to say but are too kind to say is that it was an advantage to Seligman to get $4,000,000 out of the sale.

Q. In December 1929?

A. I get your point perfectly and I have answered you to the best of my ability.

The Goldman Sachs Trading Corporation

Another example of extensive repurchase activities undertaken in connection with a merger or consolidation is afforded by the combination in February 1929 of The Goldman Sachs Trading Corporation and Financial and Industrial Securities Corporation.[343] On February 3, 1929, the managements of The Goldman Sachs Trading Corporation and Financial and Industrial Securities Corporation concluded negotiations for a sale of all the assets of Financial and Industrial Securities Corporation to The Goldman Sachs Trading Corporation, which was to be submitted to a vote of the stockholders of Financial and Industrial Securities Corporation on February 21, 1929. The agreement provided that The Goldman Sachs Trading Corporation would increase its existing 1,125,000 shares, by the declaration of a 100% stock dividend, to 2,250,000 shares and would issue an additional 2,250,000 shares of its stock to the holders of the 1,700,000 shares of the stock of Financial and Industrial Securities. In other words, each share of stock of Financial and Industrial Securities Corporation would be exchangeable for 1 11/34 shares of the new stock of The Goldman Sachs Trading Corporation.[344]

On February 2, 1929, the market price of the existing stock of The Goldman Sachs Trading Corporation was $136.50.[345] After the declaration of the 100% stock dividend contemplated by the merger plan,[346] the stock of The Goldman Sachs Trading Corporation would presumably have a market price of $68.25 a share, or one-half of its existing value. On this basis 1 11/34 shares of such stock would have a total market value of approximately $91. However, on February 2, 1929, each share of the stock of Financial and Industrial Securities Corporation had a market value of $140 a share. As a consequence, unless the market price of the stock of The Goldman Sachs Trading Corporation increased substantially between February 2, 1929 and the meeting of the stockholders of Financial and Industrial Securities Corporation on February 21, 1929, acceptance of the terms of the merger would entail a large loss in market values on the part of the stockholders of Financial and Industrial Securities Corporation.

On February 4, 1929, The Trading Corporation commenced to purchase its own stock on the New York Curb Exchange,[347] and be-

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[343] A more detailed discussion of the repurchase activities engaged in by The Goldman Sachs Trading Corporation in connection with its absorption of the assets of Financial and Industrial Securities Corporation, is contained in Ch. IV of this part of the report, pp. 1522 et seq.

[344] Public Examination, The Goldman Sachs Trading Corporation, at 16126, et seq.; Commission's Exhibits Nos. 1679, 1680, and 1681.

[345] Id., at 16137 and Commission's Exhibit No. 1665.

[346] The 100% stock dividend in reality merely constituted a 2 for 1 split-up of the stock of The Goldman Sachs Trading Corporation.

[347] Until February 7, 1929, trading was confined to the existing stock of the trading corporation and the figures used in the text are those for the old stock. Thereafter the figures used in the text refer to the stock of the trading corporation outstanding after declaration of the 100% stock dividend on shares on February 7, 1929, and the issuance,

tween the 4th and 7th, inclusive, of February 1929, this investment company purchased 174,400 shares at progressively higher prices at a total cost of approximately $33,350,000 and sold only 4,500 shares for total proceeds of approximately $975,000.[348] Its purchases constituted over 60% of the total trading on the New York Curb Exchange in that stock in those four days,[349] and undoubtedly contributed to the sharp rise in its market price.[350] The market price of the stock rose from $136.50 per share on February 2, 1929,[351] a price 30% in excess of its asset value,[352] to $222.50 per share on February 7, 1929, a price equivalent to twice its asset value.[353]

The market price for the existing shares of the stock of The Goldman Sachs Trading Corporation established on February 7, 1929, after giving effect to the declaration of a 100% stock dividend, was equivalent to the market value of the stock of Financial and Industrial Securities Corporation, on the basis of the terms for the exchange of the securities of the two companies contemplated by the plan for their combination.[354] On February 21, 1929, the stockholders of Financial and Industrial Securities Corporation approved the sale of this company's assets to The Goldman Sachs Trading Corporation.

By March 14, 1929, when The Goldman Sachs Trading Corporation's market activities in its own stock had terminated, it had accumulated 560,724 shares of its own stock,[355] or 12.5% of its then outstanding shares [356] at a cost of $57,021,936.[357] More importantly, the cost of these shares exceeded their asset value by approximately $23,000,000. As Mr. Catchings conceded, this $23,000,000 valuation in excess of the actual asset value of the treasury shares represented only a self-appraisal by Goldman Sachs & Company of the value of its management ability. Mr. Catchings testified: [358]

A. Your question as I understand it is what does that $23,000,000 represent to me. I say that represents to me that part of the market price of the stock or the cost * * * which was in addition to the asset value and that it was

on February 21, 1929, of 2,250,000 shares to the stockholders of Financial and Industrial Securities Corporation.

[348] Op. cit. supra, note 344, at 16140–4, and Commission's Exhibit No. 1665. On February 4, 5, 6, and 7, The Goldman Sachs Trading Corporation stock closed at new high prices which were made by its purchases on each of these days. The closing prices for the stock on these days were 178, 179⅝, 187⅞, and 221, respectively (id., at 16148–52 and Commission's Exhibit No. 1665).

[349] Op. cit. supra, note 344, at 16141–3.

[350] Id., at 16128–34.

[351] Id., at 16137 and Commission's Exhibit No. 1665.

[352] Id., at 16157.

[353] Id., at 16141–4 and Commission's Exhibit No. 1665.

[354] After giving effect to the declaration of the 100% stock dividend, the stock of The Goldman Sachs Trading Corporation would have a market price of $111.25 a share, equivalent to one-half of its previous market value. Stockholders of Financial and Industrial Securities Corporation would receive 1 11/34 of such shares having a marked value of approximately $148 for each share of their own stock which on February 7, 1929, had a market value of approximately $148.

[355] Op. cit. supra, note 344, at 16221–3. Of this block 98,000 shares were included in the assets of the Financial and Industrial Securities Corporation which were acquired by The Goldman Sachs Trading Corporation on February 21, 1929 (id., at 16217 and Commission's Exhibit No. 1683).

[356] Op. cit. supra, note 344, at 16221.

[357] Id., at 16221–3.

[358] Id., at 16231–5.

part of the total market price of the stock. It could be used in sale or exchanged for property.

Q. You bought that stock?

A. You know perfectly well what it is, it is a premium on asset value.

Q. Now that premium is attributable to, or is paid for, management.

A. It is paid for the possibility of making money.

* * * * * * *

Q. So you are not disputing that the ultimate management is the biggest single factor in the premium aspect.

A. Not bigger than business conditions, but I will say it is a great element.

Q. So that as a necessary conclusion to that statement it seems to me that Goldman Sachs & Company was paying $23,000,000 premium for its own management; isn't that so?

* * * * * * *

A. Twenty-three million dollars premium on the stock, a considerable part of which was predicated on management of the corporation by Goldman Sachs & Company. That is correct.

* * * * * * *

Q. I can see, Mr. Catchings, where a person making an investment—investment to my mind denotes investing in the other person's ability—but I have difficulty in visualizing a corporation paying a $23,000,000 premium on its own management.

A. I don't think you have much difficulty with that if you take into consideration the fact that the stock was actually used to acquire property from other people and actually sold for cash. I grant you it would be a silly thing to pay that premium for the stock and then retire it. I don't see any reason to do that, but to pay the premium for the stock and then use that stock to buy other property, or to sell it for cash, I don't think anything is wrong.

Q. At the time you had that position you had no assurance that you could dispose of that stock?

A. We had only a business expectation that we could be able to do it.

Q. So that at that physical point of time the situation was that you had a block of your own stock upon which you paid a premium of $23,000,000, which represented substantially your own management; isn't that so?

A. We have covered that point before. I say partially so.[359]

Moreover, Mr. Catchings conceded that at the time the investment company was accumulating the shares of its own stock he had no concrete plan for their disposition:[360]

Q. Now, did you contemplate when you started this program of purchasing your stock that you would wind up with a position aggregating $46,000,000 of your own stock in addition to the $10,000,000 that you were going to find in the portfolio of Financial and Industrial Securities Corporation?

A. No.

Q. Were you a little shocked when you found yourself with $56,000,000 of your own stock at 100-percent premium within two months after you started business?

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[359] The purchases by The Goldman Sachs Trading Corporation of its own stock at prices above the asset value of such stock is one of the few instances of this practice which the Commission's study disclosed (id., at 16235–6). In April 1929 the New York Curb Exchange amended its regulations for the listing of the securities of investment companies to require that listed investment companies agree not to effect repurchases of their own securities at prices higher than the asset value of such securities. See Pt. Two of this Report (House Doc. No. 70, 76th Cong.), Ch. IV, Appendix F.

[360] Op. cit. supra, note 344, at 16249–51.

A. I wasn't shocked.

Q. Were you a little upset about your condition about finding the corporation that was in business three months * * * owning $56,000,000 of its own stock, for which it paid a premium of $23,000,000? You weren't concerned about that at all?

A. I wasn't concerned in the sense of having anxiety about it. As a result of acquiring the stock, I had then to dispose of the stock by selling it and by getting assets in order to complete the transaction and make money on it.

Q. Now, before you started purchasing the stock, had you made any arrangements with respect to how you were going to dispose of this block of stock that you knew you would have to wind up with?

A. No.

* * * * * * *

Q. You had no specific instance in mind where you contemplated that you were going to exchange $57,000,000 for somebody else's property, did you?

A. No; we didn't know at the beginning that we were going to get that much stock.

The stockholders of The Goldman Sachs Trading Corporation never became aware of the substantial repurchases of its own stock which the company had made in connection with its acquisition of the assets of Financial and Industrial Securities Corporation. By September 1929, prior to the publication of any financial report to its stockholders, The Goldman Sachs Trading Corporation had succeeded in selling or exchanging for other securities all of its holdings of its own stock. Substantial losses were suffered by the investment company on the securities which it had acquired in exchange for its own repurchased stock.[361]

In some instances the investment companies were caused to effect substantial repurchases of their securities to remove opposition to mergers or consolidations. For example, Chicago Investors' Corporation was an investment company organized on August 3, 1927, and at June 30, 1931, possessed net assets of $6,816,316, represented by 146,018 shares of convertible preference stock and 450,000 shares of common stock.[362] In July 1931, Field, Glore & Co., the principal sponsor of the investment company, sold 100,000 shares of its holdings of this common stock to Atlas Corporation at $4 a share, with the consent of the management of Chicago Investors' Corporation.[363]

Although this acquisition by Atlas Corporation was thought to be merely for investment purposes,[364] it subsequently appeared that Atlas Corporation was seeking to obtain control.[365] Thereafter, Atlas Corporation acquired 32,700 preference shares, which possessed one vote a share, at an average cost of $23.50 a share [366] and owned or controlled 150,000 common shares at an average cost of $3.50 a share.[367]

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[361] For details of the disposition made of these shares see Ch. IV of this part of the report, pp. 1523 et seq.

[362] Reply to the Commission's questionnaire for The Chicago Corporation, Pt. I.

[363] Public Examination, The Chicago Corporation, at 9789–90. At that time the common stock, which possessed no asset value (op. cit. supra, note 362, Pt. II), was selling at $2 a share.

[364] Public Examination, The Chicago Corporation, at 9791.

[365] Id., at 9791–2.

[366] Derived from supplementary information supplied the Commission for The Chicago Corporation.

[367] Ibid.

In the summer of 1932 the directors of Chicago Investors' Corporation became aware of these additional acquisitions and a "standstill" agreement was reached with Floyd Odlum, president of Atlas Corporation. This agreement provided that Atlas Corporation would refrain from purchasing additional shares of Chicago Investors' Corporation pending the formulation of an exchange offer of Atlas Corporation shares for Chicago Investors' Corporation shares, which offer was to be submitted to the directors of Chicago Investors' Corporation.[368] In the meantime, a merger proposal between Chicago Investors' Corporation and Continental Chicago Corporation upon a share-for-share basis was developed. This merger was expected to effect a reduction in the percentage cost of operation of Chicago Investors Corporation, then estimated to amount to 2% of its then assets of $3,000,000, and also would protect the management against any threat to their control.[369] However, Atlas Corporation was in a position to block the merger, and overtures were thereupon made to it to declare its terms. In September 1932 Mr. Odlum advised the board of directors of Chicago Investors' Corporation that he was unwilling to remain in a large minority position and that the "standstill" agreement was terminated. He thereupon submitted proposals containing the three alternatives of an exchange offer, a purchase offer, and an offer to sell his preference stock at $30 a share (the approximate asset value) and to participate with his common stock in the proposed merger (by exchange of stock) with Continental Chicago Corporation.[370] A compromise was finally reached whereby Chicago Investors' Corporation repurchased the 32,700 preference shares held by Mr. Odlum for $23 a share, the approximate cost, at which time the market price was $16–$17.50 a share.[371] The merger was effected with Continental Chicago Corporation on December 20, 1932, by the creation of The Chicago Corporation, and Atlas Corporation received less than 5% of the common stock of the new company in exchange for its holdings.[372] The remaining preference stockholders of Chicago Investors' Corporation received preference stock of the new company having a market value equivalent to the market value of their old shares, $17 per share.

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[368] Ibid.
[369] Ibid.
[370] Ibid.
[371] Ibid.
[372] Op. cit. supra, note 364, Commission's Exhibit No. 928; see also op. cit. supra, note 362, Pt. I.

Chapter IV

PROBLEMS IN CONNECTION WITH SHIFTS IN CONTROL, MERGERS, AND CONSOLIDATIONS OF INVESTMENT COMPANIES

I. INTRODUCTION

This chapter will deal only with shifts in control of, exchange offers for the securities of, and the dissolution, merger, consolidation, or sale of, the assets of management investment companies. The switching of certificate holders in fixed and semifixed investment trusts and in installment investment plans from one trust to another by means of exchange offers and the shifts in control of depositor or sponsor corporations are discussed in the Commission's supplemental reports, namely, Fixed and Semifixed Investment Trusts, and Companies Sponsoring Installment Investment Plans.

The crash in the securities markets in 1929 and the resultant sharp losses suffered by investment companies created public disfavor of such companies and their managements. This reaction was reflected in the market prices of investment company securities which began to sell at substantial discounts from their asset values.[1] As has been

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[1] Floyd B. Odlum, the president of Atlas Corporation, which, from 1930 to 1936, acquired control of and ultimately assimilated the assets of 19 investment companies, testified (Public Examination, Atlas Corporation, at 17719–21) :

> * * * I had seen a considerable amount of the development that took place during that period, and by "that period" I mean '28 and '29, in the organization of investment trusts. I had followed their respective careers very closely through the '29 period, and I had seen what happened to them in the latter part of 1929. I knew that the situation in the investment trust field stood at that time about as follows: The senior securities of the investment trusts were selling at very heavy discounts below their face value even though they were covered by assets. The low-priced leverage stocks of investment trusts were either—or, rather, were selling at premiums over their asset value still; that is, where they had very small or no asset value. * * * The securities of those companies had fallen from an extravagant [market] premium over their asset values to these discounts. Their managements were paralyzed; they were stunned, so to speak. They didn't know where they were going. They had taken and bought securities in their portfolios at 1929 levels, and it is human nature when you buy a thing high that you still think you are going to make a profit if you hang on to it, and they wouldn't let go, and the market was carrying them still further and further down.
>
> On the other hand, the stockholders of those companies were very indisposed toward the respective managements. They were sore and added to that the fact that the securities were practically in investment companies what we term "green goods." They were unrefined and unsalable. There was no particular market for them.
>
> Now, that was the thing that I knew generally and which I checked and found to be the fact specifically in a great number of cases. You take, by and large, the fact that securities of investment trusts were selling at that time at about 35 to 40 per cent below the value of the assets behind their securities. Now, that will vary as to companies, because you sometimes have that premium on the common and discount on the preferred, but, roughly, I would say about 35 per cent would be a fair figure.

The figures stated by Mr. Odlum are in accord with the results of the Commission's statistical studies of investment trusts and investment companies. See the discussion of the premium and discounts at which common stocks of leverage and nonleverage investment companies sold in the market during the period from 1929 to 1936, in Part Two (House Doc. No. 70, 76th Cong.), Ch. IV. See also the testimony of Ralph W. Simonds, a director and vice president of Yosemite Holding Corporation at its inception (Public Examination, The Equity Corporation, at 1487–9).

indicated elsewhere in this report,[2] the majority of investment companies had been formed by investment bankers and securities brokers. With the collapse in the market value of securities, their interest in their companies had to a large extent diminished. The utility of their investment companies as a source of underwriting and brokerage commissions had substantially decreased. Their security interest in their investment companies had lost all, or almost all, asset value and had diminished substantially in market value. The value of option warrants to purchase stock of their investment companies which they had received as management or underwriting compensation had also become worthless. The management contracts which they had entered into with their investment companies had become of little value, and the poor performance of these companies had reflected seriously upon their prestige and reputations as financial experts. In sum, the managers of investment companies were burdened with the responsibilities of management, but the emoluments of such management had substantially diminished. As a consequence, many managers of investment companies were desirous of severing their connections with their investment companies.[3]

An era of transfers of control and acquisition and amalgamation of investment companies ensued.[4] From 1929 to 1935, exchange offers of securities of closed-end management investment companies either in connection with a merger, consolidation, or dissolution of another such company or as a preliminary thereto totaled $830,756,000 on the basis of the value of the acquired securities recorded on the books of the acquiring companies. The dollar value of securities issued by way of exchange offers constituted approximately 25% of the total of

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[2] Part Two (House Doc. No. 70, 76th Cong.), Ch. II, Table 25. In Ch. I of this part of the report it was said:

> In particular, houses of issue, brokers, and security dealers sponsored and undertook the distribution of the securities of investment company after investment company, these types of sponsorship accounting on the basis of assets for over 60% of management investment companies proper in 1929.

[3] Philip L. Carret, the president and a director of American, British & Continental Corporation, testified with reference to the sale of control of that company by J. Henry Schroder Banking Corporation and Blyth & Company to Atlas Corporation on January 9, 1932 (Public Examination, American, British & Continental Corporation, at 4777):

> Q. Have you any distinct recollection as to what the primary reason was for selling the control [of American, British & Continental Corporation] at the end of 1931 * * *?
> A. I have no knowledge of any reason.
> Q. Did you have an opinion?
> A. I might make a guess.
> Q. What is your guess?
> A. My guess is that the banking sponsors were tired of seeing the market go down.
> Q. And that they were glad to get rid of it, perhaps?
> A. Yes.
> Q. Was the feeling of despondency pretty general, that the situation was beyond rescue?
> A. There was a despondency in Wall Street. Let us put it that way.

[4] Offers to purchase control were even advertised in newspapers. For example, one advertisement stated (*The New York Times*, February 28, 1936, p. 33):

> WANTED * * * THE CONTROL OF AN INVESTMENT TRUST OR A COMMERCIAL FINANCING COMPANY.
> One of our clients, a large investment banking firm, is interested in acquiring the controlling interest in an established licensed investment trust of management type—or a commercial financing company, etc. * * *.

Joseph Meyer, Jr., one of the sponsors and managers of Oil Shares, Inc., the control of which was, as will be indicated later, shifted to a group of individuals with unfortunate

$3,109,594,000 of closed-end investment companies securities (including investment-holding companies) issued between 1929 and 1935.[5] In many cases, mergers and consolidations were undoubtedly dictated solely by the necessity for further economies in operation and management which were required by the depression. In other cases, however, the shifts in control and the amalgamation of investment companies were inspired by motives of pecuniary gain to the vendors of control which were not necessarily consonant with the interest of the public investors.

Companies were formed after the crash of the securities markets of October 1929 for the express purpose of absorbing other investment companies.[6] So widespread were the operations of those seeking con-

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consequences to its stockholders, testified before the Commission (Public Examination, Oils & Industries, Inc., at 14175–6):

A. There were so many things going on during that period [1929–1933].
Q. Well, what things were going on?
A. I mean lots of trades and a lot of acquisitions of trusts; the bigger trusts buying the smaller trusts and all that.
Q. You mean there came a period of American financial history where these investment trusts were being sold like chattels; isn't that so?
A. Well, they were being absorbed.
Q. They were just being sold like chattels without particular consideration? The inside management groups were just transferring their control to other interests. We all know that substantially that is what transpired. That is all through that era there.
A. Well, I don't know if I want to put it that way. All I will say is that the smaller trusts were being absorbed by the larger trusts. We all know that, and you know how it is. A good contact man * * * might come in and try to sell the Equitable Building, although he has no right to sell the Equitable Building, and all that sort of thing was going on.
Q. Everybody was ready to buy and ready to sell investment trusts?
A. In those periods they would sell you anything you would take.

See also Part Two (House Doc. No. 70, 76th Cong.), Ch. II, Table 16, for the number of investment trusts and investment companies organized and becoming inactive annually from 1927 to 1936.

[5] Part Two (House Doc. No. 70, 76th Cong.), Ch. III, Table 62.

[6] One of such companies was The Equity Corporation, whose activities will be described infra, pp. 1039–52. Another of such companies was Yosemite Holding Corporation, organized in Delaware on November 8, 1929, under the sponsorship of Baker, Simonds & Company and the Fidelity Trust Company of Detroit. (Public Examination, The Equity Corporation at 1367 and Commission's Exhibit No. 188.) During the management of the company by these sponsors it negotiated for control of 14 investment companies—American Bankers Investment Company, American Shares, Inc., Alexander Hamilton Shares Corp., Atlantic Midland Corporation, Atlantic and Pacific International Corporation, Berner Smith Company of Buffalo, Chippewa Share Corporation, Detroit Bond and Share Corporation, F. L. Andrews Investment Trust, Iroquois Share Corporation, New Jersey Bond & Share Trading Corporation, Genesee National Corporation, Select Investors, Inc. (id., at 1490–5)—but actually absorbed only Union Investors, Inc. (See infra, pp. 1296–1302.) Control of Yosemite Holding Corporation itself was acquired in 1931 by Wallace Groves. (See Ch. II, of this part of the report, pp. 181–227, and infra, pp. 1034–7.) Control of Yosemite Holding Corporation was thereafter acquired in 1932 by The Equity Corporation, which eventually absorbed its assets. (See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, p. 199.)

Ralph W. Simonds, a partner in Baker, Simonds & Company and a director and vice president of Yosemite Holding Corporation at its inception, described the factors which fostered the possibility of acquiring and amalgamating investment companies after 1929, as follows (Public Examination, The Equity Corporation, at 1363, 1365–6):

A. * * * The crash had come and most of us were of the opinion that we had seen the worst, and at the same time it was a difficult time to raise money for a trust or holding company. It was a difficult time to raise money through the sale of original capital, and the idea was brought to me—I can't tell exactly where it came from—that it was an excellent time to form a holding company to acquire trusts, and through

trol of investment companies that some managements adopted measures to strengthen their domination of the policies of their companies.[7]

A. Purposes of Acquisition of Control of Investment Companies

According to some sponsors, the transfer of control of and the merger or consolidation of investment companies in many cases may have been motivated by the necessity for effectuating reductions in operating and management costs.[8] In numerous other cases, however,

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the leverage feature that people who would buy into the equity would profit as the depression was cured.

* * * * * * *

Q. You made the observation that it came back to you that this was a propitious time to acquire investment trusts. What created that situation?

A. Just what do you mean by that question? Do you mean what created it in my mind, or what brought about the actual fact?

Q. What brought about the situation that made it easy to acquire investment trusts?

A. It wasn't easy * * * trusts were available and a good many of them had dissension in their management and it was possible to work out deals to acquire them, but it was not easy at all. And there was great competition to acquire them.

Q. In connection with the acquisition of these leverage trusts, the only way in which a trust acquiring another trust with a leverage factor could hope to make any profit or have gain was at the expense of the senior security holders; isn't that so?

A. I wouldn't necessarily say that, because the senior security holder has a preference. He takes a limited return on his capital and foregoes profits for that senior position and the safety factor, so I wouldn't say it was at his expense.

Q. But wasn't the technique this: After you, the investment trust, had control of the voting stock of a leverage trust, the technique was to acquire the senior securities at less than their liquidating value. * * *

A. Yes * * *.

The character of many of the "deals worked out" with the managements of acquired investment companies will be described infra, pp. 1078–1357.

[7] Thus, in October of 1931, J. & W. Seligman & Company, the sponsors of Tri-Continental Corporation, an investment company possessing or managing pursuant to contracts with other companies, gross assets then totaling approximately $100,000,000, obtained, with the consent of the corporation's stockholders, a contract to manage the corporation and an amendment to the corporation's charter providing for the classification of directors by period of tenure of office and permitting the election of various directors for varying terms in excess of one year. (Reply to the Commission's questionnaire for Tri-Continental Corporation, Pt. IV, Exhibit IV, 17–G.) The purpose of these moves was to discourage any attempt by others to secure control of Tri-Continental Corporation by the purchase in the open market of its equity securities. On this point Earle Bailie, the chairman of the board of directors of Tri-Continental Corporation and a partner in J. & W. Seligman & Company, testified (Public Examination, Tri-Continental Corporation, at 18645–7):

Q. Why was the first management contract between Tri-Continental and Seligman initiated 2 years after the corporations were started? That was in 1931, wasn't it?

A. Yes. The reason was, at that time, as you will remember from looking at the market prices of the securities and as you will remember from the general market conditions, investment company equity securities were selling at very low prices, and there were several groups of capitalists or investors, describe them as you will, who were busily acquiring the equity securities of investment companies in order to take over their managements and in order to build up other companies. With the interest we had in Tri-Continental because of our sponsorship and with the feeling of responsibility we had, we wished to ask the stockholders whether or not they wanted to have a definite management contract with us which would prevent that happening to Tri-Continental. We submitted the management contract and it was approved.

* * * * * * *

Q. It [the management contract] ran until 1947, when it was to be terminated by either party on a certain amount of notice; is that correct?

A. Exactly.

Q. So that would give you a certain amount of security to the management, wouldn't it?

A. Correct.

Q. Secondly, you arranged to put——

A. (Interposing.) We classified directors.

Q. The staggering of directors prevented a sudden change; isn't that right?

A. Exactly.

Q. By a new person acquiring the stock of Tri-Continental and removing all directors?

A. The purpose of that transaction was to make it unattractive to the person acquiring it.

[8] This motive was, according to the testimony of Earle Bailie, chairman of the board of directors of Tri-Continental Corporation, the underlying factor in the absorption by Tri-

motives perhaps less compatible with the interests of the stockholders existed. The aggregate market values of shares in investment companies following the close of 1929 was approximately 35% less than the actual value of the assets of these companies. In this situation a profit equivalent to the difference between the market and asset values of investment company shares would be made by acquiring the outstanding shares of investment companies for a consideration equivalent to or less than their market value. Moreover, the acquiring corporation could pay such consideration for the shares and assets of an acquired company not in currency but in stock certificates printed and issued by the acquiring corporation. By the utilization of the legal processes of dissolution, merger, or consolidation, the purchasing corporation could realize the actual asset value of the shares acquired.[9]

Other "objectives" of acquisition, however, could be obtained by much simpler techniques. Profits could be made by persons by the simple procedure of acquiring control of several investment companies and thereafter selling one of the controlled investment companies to another at a profit.[10] Other individuals, also attracted by the essential liquidity of the assets of investment companies and the virtual absence or ineffectiveness of any legal supervision of their activities,[11] ac-

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Continental Corporation in the period between 1929 and 1936 of the assets of Tri-Continental Allied Co., Inc., Wedgwood Investing Corporation, Investors Equity Company, Inc., and Graymur Corporation, and in its acquisition of control of or a substantial voting influence in Selected Industries, Inc., Broad Street Management Corporation, Capital Administration Company, Ltd., Broad Street Investing Co., Inc., and Blue Ridge Corporation. All of these latter companies were managed by Tri-Continental Corporation pursuant to the terms of management contracts, and the effect of the acquisitions was to lower the cost of management of the entire group of assets under the control of Tri-Continental Corporation (Public Examination, Tri-Continental Corporation, at 18565, 18583). See also supplementary information furnished the Commission by Tri-Continental Corporation, Item XXIII, which states:

> The present Tri-Continental Corporation has from the beginning been committed to the policy of maintaining an adequate staff for administration and investment research. * * * The rapidity and seriousness of the decline in security values during that period [1930–1931] only served to emphasize the necessity for adequate research facilities. At the same time the shrinkage in value of assets in the portfolio made the burden of carrying a large and competent staff increasingly heavy. The management saw the opportunity to reduce this burden and to make possible continuance and further development of the research staff by (a) acquiring additional assets so that the cost of management might be spread over a larger base and (b) by selling investment service to others.

[9] The expansion and growth of Atlas Corporation and The Equity Corporation are illustrative of this method of amalgamation of investment companies. These corporations and their subsidiaries alone represented ultimately an amalgamation occurring between 1929 and 1936 of approximately 44 investment companies. See infra, pp. 1039–72.

In Part Two (House Doc. No. 70, 76th Cong.), Ch. III pp. 209–11, in discussing the amount of securities issued by Atlas Corporation and The Equity Corporation in connection with their acquisition of control of investment companies, it was said:

> The companies in the Atlas Corporation and The Equity Corporation groups issued securities amounting to $529,000,000 for exchanges in connection with acquisitions during the 1927–1935 decade, or 61% of the total value of all securities so issued. The value of securities issued by all closed-end management companies proper and investment-holding companies by this method was 21% of the total value of all securities sold and exchanged by such company during the years from 1927 to 1935. The value of the securities so exchanged by companies in the Atlas and The Equity Corporation groups was over 34% of the total value of all securities sold and exchanged by these companies.

[10] This essentially was the procedure adopted by both Wallace Groves and Donald P. Kenyon, whose activities in the amalgamation of investment companies have already been described in detail in Ch. II of this part of the report, pp. 227–308 and pp. 309–50.

[11] See Ch. I of this part of the report, pp. 1–31.

quired control of such companies for the purpose of diverting their assets to their own purpose.[12]

Of course, the incumbent managements of investment companies might constitute an obstacle to the acquisition of the assets or shares of their investment companies. These dominant persons, as the fiduciaries of their stockholders [13] who had already suffered large losses under their managements, might have refused to "sell their stockholders down the river" [14] or at least might have protected the rights of the public investor after the sale of control to others. However, as has been indicated, existing managements were desirous of severing their connection with their investment companies. Apparently, for a consideration, some of these managers were induced to forego their fiduciary duties to their stockholders and either to cooperate actively with the acquirer in the effectuation of his objectives or at least to refrain from opposing those activities of the new management which would result in loss to the stockholders of the acquired company. In practically no instance of disposition of control did the retiring managements insist on the maintenance of the existing investment policies of their companies or retain a membership on the directorates of the companies for the purpose of protecting the interest of public stockholders.[15] Usually, only a cursory investigation of the integrity, responsibility, and ability of the new management was made by retiring managements who had been well compensated for their transfer of control and management.[16] Nor did the retiring managements require the purchasers of their shares to make an offer to purchase the securities of minority stockholders on terms equal to those accorded the management.

Moreover, in many cases, a dissolution of the investment companies rather than a shift in control would have prevented the losses which frequently resulted from the self-dealing acts of the new controlling group. Similarly, in many cases a dissolution rather than a shift in control of their companies would have resulted in the stockholders receiving as the distributive portion of their companies' assets, amounts which, if then invested in the securities of the acquiring

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[12] The activities of the organizers of Fiscal Management Co., Ltd., and of Northern Fiscal Corporation, which will be briefly described infra, pp. 1072–8, are illustrative of this abuse. See also Ch. II of this part of the report, pp. 350–496.

[13] Many sponsors and managers of investment companies conceded that their sponsoring, their managing of the assets, their presence on the directorates, and their public distribution of the securities of investment companies created a "fiduciary" relationship between themselves and the stockholders. See the testimony of Robert Schaffner of A. G. Becker & Co., Inc., the chairman of the board of directors of National Securities Investment Company, infra, pp. 1113–14; Gerald Beal, of J. Henry Schroder Banking Corporation, the president of Continental Securities Corporation (Public Examination, First Income Trading Corporation et al., at 421–5 and 431–3); and C. K. Reynolds, president of Reynolds Investing Company, Inc. (id. at 1151–4). For a detailed discussion of the losses suffered by the security holders of Continental Securities Corporation and of Reynolds Investing Company, Inc., as the result of the transfer of the control of such corporations to Fiscal Management Company, Ltd. and its organizers, see infra, pp. 1072–8, and Ch. II of this part of the report, pp. 350–496.

[14] Public Examination, First Income Trading Corporation et al., at 417.

[15] See the cases discussed infra, pp. 1085–1357, and see also Ch. II of this part of the report, pp. 350–496, for details of the activities of the Fiscal Management and Northern Fiscal groups, and the same chapter, pp. 497–623, which relate to the management of General Investment Corporation by Ernest B. Warriner.

[16] The methods adopted to secure the support of existing managements will be more fully described infra, pp. 1085–1357.

corporation, would have resulted in greater gains to stockholders than may have eventually accrued to them by the exchange of their shares for those of the acquiring corporation. For several reasons, however, the alternative of dissolution rather than a shift in control to another corporation or individual was not offered to the stockholders. First, the acquiring individuals made it more pecuniarily attractive for sponsors and managers to shift control rather than dissolve the companies. Second, preferred stockholders in leverage investment companies, because of their companies' capital structures as set up by the sponsors, were unable to realize their preference in assets. The common shares of leverage investment companies usually possessed no asset value after 1929. Sponsors and managers who were holders of large blocks of these common stocks and therefore had the power to decide upon a dissolution of the investment company would have received nothing in the event of a dissolution. The alternative of selling their common stock, worthless in asset value but valuable as controlling the corporate assets belonging to senior security holders, was obviously more attractive. Third, the association of the management of an investment company with an investment banking or brokerage house or with a commercial bank weighed heavily against a dissolution. The winding up of an investment company sponsored by such institutions would at once have reflected upon their prestige and reputation.[17]

Although the majority of amalgamations of investment companies occurred in an era of depressed securities prices, the methods and techniques for acquiring control of investment companies are equally workable at any time.[18]

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[17] Thus, Samuel Ungerleider, whose brokerage firm, Samuel Ungerleider & Company, managed and controlled the Ungerleider Financial Corporation before its acquisition by Atlas Corporation, testified before the Commission (Public Examination, Ungerleider Financial Corporation, at 15003–4):

Q. Your name was still in the corporation?
A. Yes, sir.
Q. That was a matter still of importance to you?
A. Yes.
Q. Did you give any thought to the dissolution of the investment trust at that time?
A. We had some conversation along that line.
Q. And what persuaded you not to do it?
A. We didn't think it was an opportune time. We had hopes there would be an improvement in market conditions and our portfolio would increase, and we were anxious not to see our stockholders lose any money.
Q. Of course, if the Ungerleider Financial Corporation dissolved, it might be a sombre reflection—I mean it wouldn't be a very pleasant thing for Ungerleider & Co. to dissolve their investment trust. It might be some implication that they had not successfully managed the Financial Corporation; isn't that so?
A. That may be. It is natural that people do not like to start something and wind it up without success.
Q. Of course, that has some significance—it might indicate some of the possible disadvantages of the association (between a brokerage house and an investment company) of such character, where there might be some implication where a certain course of conduct is followed. The fact is, June 30, 1930, the liquidating value was $49.52, so that if the trust were liquidated at that time, the stockholders would almost have gotten their money back; isn't that so?
A. If it could have been liquidated.
Q. In this particular case, there were no complications were there, because the investment company had only one class of stock?
A. That is right.

[18] The activities of Donald P. Kenyon in the acquisition of control of investment companies, which are discussed in Ch. II of this part of the report, pp. 309–349, occurred in 1935 and 1936, a period of rising securities prices; and the activities of Fiscal Management Company, Ltd., Northern Fiscal Corporation, and their organizers, which are fully described in Ch. II of this part of the report, pp. 350–496, and are briefly discussed infra, pp. 1072–8, occurred in 1937 and 1938.

B. Effects on Stockholders of Acquired Companies

The succession of an unscrupulous management to control of an investment company was almost immediately followed by a course of dealing between the new management and the company which resulted in a waste and conversion of the corporate assets to the advantage and profit of the new management and to the damage and loss of the public stockholders who were powerless to prevent such activities. In many cases, the public investors were not even aware that the control of their company had been transferred. In other cases the acquisition of control of an investment company did not have for its purpose the waste and dissipation of the corporate assets but represented an integral procedural step in a process of voluntary reorganization by which the rights and privileges and the participating interest of the acquired company's stockholders in the assets of their company were to be substantially modified. Briefly, this latter procedure of acquisition and absorption encompassed the following steps: (a) the acquisition from the sponsors and managers of control and management of the company desired in a transaction almost invariably not fully disclosed to the stockholders of the acquired company prior to its consummation; [19] (b) the purchase of the shares of the investment company held by the public at prices less than the asset value of such shares; (c) the acquisition of additional shares held by the public by means of exchange offers of the acquiring corporation's securities the asset value of which was less than the asset value of the securities received. Occasionally control of the investment company was also acquired by means of an exchange offer following a preliminary agreement by the acquirer with the sponsors and managers of the acquired company which assured to the acquirer the aid of these individuals in inducing acceptance of the exchange offers; (d) ultimately, the acquiring corporation realized its asset gains by absorbing the assets of the acquired companies by dissolution or consolidation. Fundamentally, therefore, the acquisition of their investment companies involved an immediate further loss of asset values to stockholders of acquired companies.

1. UNDISCLOSED SHIFTS IN MANAGEMENT AND INVESTMENT POLICIES

Control of investment companies' funds was shifted to new managers without the consent of the public stockholders and in many cases without their prior knowledge. New managements often unscrupulously wasted the assets of these investment companies or converted these assets to their own benefit with attendant losses to the stockholders. Apparently the incumbent managements completely disregarded the fact that the public may have invested in a particular investment company on the basis of its estimate of the integrity, responsibility, and investment abilities of the original management of such companies.[20] Nevertheless, without the prior knowledge or con-

[19] The necessity for the acquisition of control as a preliminary step in the reorganization process will be described infra, pp. 1080–5.

[20] Earle Bailie, the chairman of the board of directors of Tri-Continental Corporation, indicated that a transfer of management without previously informing the stockholders

sent of the stockholders, shifts in the management personnel and in the investment policies of investment companies were of frequent occurrence.[21]

In fact, frequently associated with the process of acquisition and amalgamation of investment companies was the use of a controlled

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of the personnel of the new management and its investment intentions may be inequitable. He testified (Public Examination, Tri-Continental Corporation, at 18874–5):

> Q. You say, "how will they justify to the stockholders of these companies this sell 'down the river' by a governmental body which does not consult their wishes and does not guarantee the success of the management which must replace the present officers and directors?" I am interested in this "selling down the river." We have a different phrase for an analogous situation, and that is the business of "trafficking" in investment trusts.
>
> A. Yes; and I have tried to cover that by saying I do not think management should be able to be transferred.
>
> Q. There is no reference in your memorandum [Mr. Bailie's recommendations with reference to regulation of investment companies] to shifts in control?
>
> A. Then limit it at this point. I puzzled a great deal over the practical method of working out what I am going to say. But I think before a group of stockholders have a wholesale shift in directors or management that they should be consulted in a meeting and should know who their new managers are. You will realize that comes under one of my suggestions that the new directors and their affiliations and past connections have to be outlined and sent out.
>
> * * * * * * *
>
> Q. I think you concurred in the idea that the most important element, of course, is management. That is all there is.
>
> A. Exactly. When a man buys an existing management he certainly ought to know who the new management is and should be consulted before it goes in.

Recently in *Oil Shares, Inc.* v. *Kahn*, 94 F. (2d) 751 (C. C. A. 3rd 1938), the court, at least inferentially, suggested that the control of an investment company is akin to a power in trust for the benefit of the company's stockholders. In this case the management, without consulting or obtaining the prior consent of the stockholders, had transferred control of an investment company to an unscrupulous group of individuals who thereafter converted a substantial portion of the company's assets to their own use. (See infra, pp. 1293–6 for a description of the transfer of control of Oils & Industries, Inc., and Ch. II of this part of the report, pp. 94–115, for a detailed discussion of Oils & Industries, Inc.) In its opinion the court said:

> The individual members of the old board are not before us and we have no thought of criticising them unheard, but no one more than they now realize the serious mistake they made. Reference to the date of this transaction would in itself soften criticism of what any board of directors did whose corporation was in dire need of funds to be supplied by fresh capital. Overeagerness to get the money would blind them to the need of looking closely into the source of its supply. Nonetheless any board which did what this board did would be taking upon itself a grave responsibility. The assets of their corporation belonged to the then stockholders. What the board did was to turn over these assets to the control of a new board without asking for the sanction of the stockholders to whom the assets belonged. Nothing would excuse them for taking this responsibility upon themselves except to have what was done turn out well. If it turned out otherwise, as here, they could not escape deserved criticism. Good intentions would not avail them as a defense.

[21] The history of Interstate Equities Corporation is illustrative of the rapidity with which shifts in the management of investment companies occurred. Interstate Equities Corporation had been incorporated in 1929 under the sponsorship of the investment banking house of Bancamerica Blair Corporation (Public Examination, The Equity Corporation, at 11 and Commission's Exhibits Nos. 1 and 2). Edward R. Tinker had been the first president of the company. Under the management of Bancamerica Blair Corporation, Interstate Equities Corporation had invested in diversified securities and had participated in the underwriting of security issues (id., at 13). In 1931 Wallace Groves acquired control of Interstate Equities Corporation and caused it to trade actively in portfolio securities. (See Ch. II, of this part of the report, pp. 181–226.) In December 1932 Interstate Equities Corporation became a subsidiary of The Equity Corporation, then controlled by Wallace Groves. In May 1933 David Milton became president of The Equity Corporation, and, as will be indicated later, the investment policy of Interstate Equities Corporation was radically altered. Its funds became the medium of further expansion by The Equity Corporation and its diversified portfolio of securities was replaced by large holdings in a few insurance and investment companies, control of which The Equity Corporation was desirous of acquiring. (See infra, pp. 1043–6.)

The reaction of stockholders to these rapid shifts in the management personnel of their company may be depicted in a letter dated July 10, 1933, to David M. Milton, the president of The Equity Corporation, by a stockholder of Interstate Equities Corporation. The

company to acquire securities of other companies eventually to be absorbed by the controlling corporation or individual. To accomplish this end, in many cases the acquired companies, while under the management of the acquiring corporation, without the prior knowledge or consent of the stockholders of the acquired company, liquidated their portfolios of diversified securities and concentrated their investments in the securities of other investment companies eventually assimilated by the controlling corporation.[22]

Thus, following the undisclosed shift in control of their companies, minority stockholders often found themselves interested in companies which no longer invested in diversified securities but which were associated with the acquiring corporation in obtaining control of other investment companies. Investment companies which formerly were not operated under management contracts, now were administered under management contracts by the terms of which the controlling corporation received annual compensation based on a percentage of the assets of the managed company.[23] A stockholder, dissatisfied with the change in policy, had no alternative but to sell his stock in the market at prices less than their actual value in assets. And the acquiring corporation, in the then condition of securities markets, was usually the only market bidder for his shares. As such sole bidder, the

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stockholder's letter states (Public Examination, The Equity Corporation, Commission's Exhibit No. 1036):

> As an Interstate stockholder, I have been Tinkerized * * * Then we were Groved * * * and now Milton controlled * * *.
> Our Tinker was financially heralded in the "Who is Who" but since his downfall * * * we know not in what experienced or inexperienced hands we were or are in. Why not be frank and give us some idea of what you hope to do for us if we exchange our securities.

[22] Examples of this type of change in the investment policies of investment companies appear infra, pp. 1043–6 and 1059–64. The acquisition of investment companies by Henderson Brothers, of Boston, is illustrative of the use of this procedure as a device by which control of large aggregates of investment company assets can be acquired with a comparatively insignificant investment. From July 1 1934 to March 1937 Henderson Brothers, who previously had been engaged primarily in the retail distribution of radios, refrgerators, and washing machines, acquired control of six investment companies by the purchase from the managements of such companies of their control holdings of common stocks with negative asset values. The investment companies so acquired were Beacon Participations, Inc., Atlantic Securities Corporation of Boston, Allied International Investing Corporation, Standard Investing Corporation, International Equities Corporation, and General Investment Corporation. In addition, a 26% interest in the control stock of Utility Equities Corporation was also acquired. However, control of these companies whose total assets approximated $35,000,000 was obtained by Henderson Brothers at a maximum personal expenditure of approximately $80,000. Control of most of the companies was acquired by the use of the assets of previously acquired companies to purchase control of additional companies. On the other hand, stockholders of the acquired companies, without their prior knowledge and consent, had become investors in companies whose diversified portfolio of marketable securities had been substantially liquidated to derive funds for the purchase of large blocks of the negative asset value equity securities of other investment companes. (Public Examination, General Investment Corporation, at 15312, et seq.)

[23] Of the 21 investment companies acquired by Atlas Corporation 11 companies (All American General Corporation, Exide Securities Corporation, Aviation Securities Corporation, National Securities Investment Co., Atlantic Securities Corporation, Chain Store Stocks, Inc., General Empire Corporation, American Investors, Inc., Shenandoah Corp., Securities Allied Corp., and Blue Ridge Corporation) had never, prior to their acquisition of their control by Atlas Corporation, been operated under management contracts providing for cash compensation for management (excluding expenses). These companies compensated Atlas Corporation annually at the rate of ½ of 1% of the value of their assets. As of December 31, 1935, a total of $1,854,548.41 had been paid by these and other investment companies as management fees to Atlas Corporation. (Public Examination, Atlas Corporation, Commission's Exhibit No. 2001, p. 3.)

acquiring corporation usually fixed a market price less than the liquidating value of the security but greater than the existing market prices of comparable securities.[24] That the market value of their shares was higher than the market values of comparable securities may have been an inducement to stockholders of acquired companies to sell their shares.

2. INEQUITABLE TECHNIQUES IN INDUCING EXCHANGES OF SECURITIES AND ACCEPTANCE OF MERGERS AND CONSOLIDATIONS

Strong pressures, which in many cases they were powerless to resist, were exerted upon stockholders to accept exchange offers. Sources of independent, unbiased advice on the merits of the exchange offers were practically foreclosed to stockholders as part of the technique of inducement of exchanges. The original sponsors and managers of the companies, in whom the stockholders presumably had confidence, were apparently induced by special treatment or other undisclosed pecuniary considerations, to recommend and solicit exchanges. In addition to this assistance from the original sponsors, the acquiring companies also used the services of a large number of security dealers who were paid on a commission basis. The salesmen employed by these dealers were supplied with stockholders' lists to enable them to solicit investors personally to make exchanges. Other brokers, dealers, and commercial banks, whom stockholders might consult as to the merits of exchanges, were offered commissions to recommend exchanges. The exchange offers did not disclose to the stockholders the payment of such commissions.

Frequently, written offers of exchanges distributed to the stockholders contained misleading financial or other information or omitted to include material facts with reference to the exchanges. And without the knowledge of exchanging stockholders, the market prices of the securities which were the subject of the exchange offers were sometimes "stabilized" during the pendency of the exchange offers.

Moreover, to await the eventual dissolution or consolidation of the investment company, as an alternative to acceptance of exchange offers, might be disadvantageous to the stockholder. On liquidation or consolidation the assets of the investment company might consist largely of securities of as yet unabsorbed investment companies controlled by the acquiring corporation. Such securities might be valued at their market value for distributive purposes on liquidation or in computing the appraisal value of their shares in the case of a consolidation. Actually such securities had asset values greater than their market values. The participation in the ultimate realization of these asset values by the stockholders could only be accomplished with certainty by their becoming stockholders of the controlling corporation.

Similar tactics were utilized to induce acceptance of the terms for mergers, consolidations, and sales of all the assets of investment companies to other companies. In many cases, as a result of previous purchases and exchange offers, the controlling corporations held the

[24] See infra, pp. 1374–83.

number of the shares of the controlled companies required by state laws for the approval of their merger or consolidation with their parent company or with other companies. Furthermore, in the face of the superior financial resources of the management, augmented by its ability to use the corporate funds to aid its plans, and its control over the stockholders' lists and the proxy machinery, individual stockholders normally were unable to resist plans for mergers, consolidations, or sales of their corporation's assets proposed by the management. Legal remedies, where available, are costly and usually beyond the means of the average stockholder. The privilege sometimes accorded by state laws to stockholders dissenting from a plan of merger and consolidation to obtain in cash an appraised value of their securities involves also an expensive and technical procedure. The existence of the privilege may not be known to the average stockholder. Moreover, in many states, stockholders are denied the privilege of obtaining an appraised value of their shares. Some states which provide for an appraisal of the shares of stockholders in the event of an amalgamation of the assets of their company with other companies, may restrict the exercise of this appraisal right to a merger or consolidation but not to the sale of the entire assets of a corporation.[25] The management usually has the sole power to select the statutory procedure to be used to effectuate its purpose.

Acceptance of the exchange offers or the terms of mergers and consolidations immediately effected a change and modification of the previous status of the stockholder. Usually a large portion of the asset value of his shares immediately accrued to existing stockholders of the controlling company. Stockholders whose companies' investment policies had been limited to investment in diversified securities became stockholders of companies then principally engaged in acquiring other investment companies or of companies with a policy of investment for the purpose of control of industrial or other corporations. Preferred stockholders in acquired companies usually became common stockholders of the acquiring corporation, or received preferred stock having substantially different preferential rights. Dividend arrearages on their stock were eliminated as the result of the exchanges. Stockholders holding common stock without asset value in leverage companies usually became only warrant holders of the acquiring corporation. Stockholders of nonleverage companies became stockholders in companies with leverage capital structures. Stockholders in corporations organized under so-called "strict" incorporation laws became stockholders of corporations incorporated under the "flexible" incorporation laws of Maryland and Delaware. Certificate holders of the "Massachusetts" type of investment trust became stockholders of corporate investment companies. Stockholders in open-end investment companies became stockholders of closed-end investment companies.[26]

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[25] See infra, pp. 1421–3, and the Commission's Report on the Study and Investigation of Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, p. 590, et seq.

[26] Jackson & Curtis Investment Associates, an "open-end" investment company, was acquired by Atlas Corporation, a closed-end investment company (Public Examination, Atlas Corporation, Commission's Exhibit No. 2001, p. 101).

C. Nonregulation of Shifts in Control, Exchange Offers, Mergers, and Consolidations

Throughout these entire processes of acquisition and reorganization and their attendant readjustment of shareholders' rights, no independent body existed with authority to supervise, regulate, or pass upon the fairness of changes in control, exchange offers, mergers, consolidations, and sales of the entire assets of investment companies. The shift in control was a private negotiation between the acquiring corporation or individual and the retiring management or sponsors of the acquired company.[27]

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[27] A controlling stockholder may transfer his shares to others at will, and even against the wishes of the minority stockholders, so long as the transfer is not part of a scheme to defraud minority stockholders. See 13 Fletcher, *Cyclopedia of Corporations*, § 5805; *Cf. Barnes* v. *Brown*, 80 N. Y. 527 (1880). However, contracts by which directors, or minority stockholders, and possibly even majority stockholders (*Fennessy* v. *Ross*, 5 App. Div. 342, 39 N. Y. Supp. 323 [1st Dept. 1896]), expressly agree as an incident to the sale of their shares or otherwise, to transfer the offices and directorships of a corporation to others, that is, to "barter away" the offices of the companies and representation on their boards of directors, are illegal as against public policy. *Fennessy* v. *Ross*, 90 Hun. 298, 35 N. Y. Supp. 868 (Gen. T. 1st Dept. 1895); *Cf. McClure* v. *Law*, 161 N. Y. 78, 55 N. E. 388 (1899).

Formerly no obligation rested upon the controlling stockholder to reveal to the minority stockholders his intent to, or the fact of, a transfer of his control to others. However, by Section 16 (a) of the Securities Exchange Act of 1934 the beneficial owners of more than 10% of any class of the equity securities of corporations which are registered on national securities exchanges, as well as the officers and directors of such companies, are required to report any changes in the ownership of their holdings of such equity securities to this Commission and to the exchange on which the securities are listed within 10 days after any change in ownership occurs. These changes in ownership are published monthly by the Commission. However, a disclosure of the price paid to these individuals for any of their equity securities is not required by the section, a fact which is clearly of importance to other stockholders who thereafter may be solicited by the purchaser of the controlling block of securities to exchange or sell their shares to him at a price less than that paid for the controlling block of shares. See infra, pp. 1092–1357 and note 72, p. 1093. Furthermore, the provisions of Section 16 (a) of the Act do not apply to the transfer of beneficial ownership of securities which are not listed on national securities exchanges. The great majority of existing investment companies do not have securities listed on natonal securities exchanges. See Part Two (House Doc. No. 70, 76th Cong.), Ch. IV, Table 86, of this report. Finally, Section 16 (a) does not apply to a transfer of control which is based not on stock ownership but on other devices, such as management contracts.

Where the controlling stockholder has an actual majority of the voting stock, the minority stockholders will ordinarily be powerless to dislodge the management to whom the shares have been transferred. However, actual control of an investment company may exist where the controlling group holds less than a majority of the voting stock, or even holds none of the stock but exercises control by means of a management contract or other control device. See Part Two (House Doc. No. 70, 76th Cong.), Ch. V, pp. 361–459. In these cases actual control is maintained by the management's domination of the proxy machinery. Of course, in these situations the actual majority stockholders, who are usually widely dispersed geographically and are normally the individual owners of only small blocks of stock (ibid.), have the theoretical power at an annual or special meeting to depose a new board of directors to whom control has been transferred after the preceding stockholders' meeting. Nevertheless, the existing directors of a corporation have the power under the general incorporation laws of most states (see, e. g., Del. Rev. Code (1935), c. 65, § 30) in the interim between stockholders' meetings to turn over their management to others by merely electing the new management as their successors and resigning. By the date of the next annual or special stockholders' meeting to elect directors the new management may have converted to its own use, or otherwise wasted, a substantial portion of the company's assets. Compare the cases described infra, pp. 1092–1357, particularly Oils & Industries, Inc., Insuranshares Corporation of Delaware, and the companies acquired by the Fiscal Management group and Northern Fiscal group. Significantly, state laws with reference to other financial institutions, such as banks, restrict the power of the boards of directors to fill vacancies caused by the resignation of one or more of their number during the interim between stockholders' meetings. For example, the New York Banking law provides that

Such shifts in control were usually advantageous to the retiring managers. Consequently, minority stockholders of these companies were represented in the shift of control to the acquiring individual only by sponsors and managers who may have been pecuniarily interested in aiding, or at least not opposing, the objectives of the acquiring corporation or individual.[28]

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bank directors may replace only one-third of their number during the interim between stockholders' meetings and further provides that the state banking superintendent must be informed of the resignation of a director within 10 days after it occurs, together with the name and occupation of the director elected by the board to replace the retiring director (Consolidated Laws of New York (Cahill, 1930), Ch. 3, §§ 126, 127).

[28] When examined upon the obligation owed by the acquiring corporation to the stockholders of the company to be acquired, Mr. Odlum, the president of the Atlas Corporation, a company which to a substantial degree engaged in a policy of acquisition of other investment companies, testified (Public Examination, Atlas Corporation, at 17750, et seq.) :

> Q. Throughout your entire acquisition campaign did you feel that you, who were contemplating acquiring control of the situation, owed any duty to the stockholders of the investment trusts whose stock you were seeking to acquire?
> A. Yes.
> Q. What did you conceive your obligation to be under those circumstances?
> A. My obligation after I came into a dominant position in their company was an obligation to make a fair trade.
> Q. What did you conceive your obligation, if any, to be to the stockholders before you came into control of the company?
> A. I had no obligation to them.
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> * * * * * * *
>
> Q. Is that predicated upon the assumption that you were dealing at arm's-length with these people?
> A. At that moment or up to that moment I was.
> Q. I know that this may be a difficult question to answer, Mr. Odlum, but at what point of time would you say that you felt that this obligation was imposed upon you?
> A. When I took over the management of the companies.
> Q. Would you say that it accrued to you after you acquired the initial block of stock from the insiders or the sponsors, even though it did not constitute a majority of the outstanding stock?
> A. If I owned a block of stock that was in no way a dominating or controlling block and had nothing to do with the management, I would have no more duty to them than every one has the duty to his fellowmen to try and do the right thing under the circumstances, just as you and I have a duty to each other right at this minute.
> Q. When you say "take over the management," you mean "went on the board of directors"?
> A. If we went on the board of directors, that very fact would carry with it some responsibility. You can't answer this thing by any definite line of demarcation, but everything that you do carries with it some degree of responsibility. Our responsibility, if I became a director of the company, I had a responsibility as a director. From a standpoint of Atlas, it certainly had a responsibility from the time it either dominated or took over the control of the management, particularly from the latter date.
> Q. Then I suppose that the converse of that situation is correct, and it may not be the precise converse, but up to the time that you went on the board of directors and took over control, the obligation of the sponsors or prior management persisted up to that point, is that correct?
> A. Well, it is hard to answer that, in that way. Certainly the prior sponsors had a certain obligation in the situation, depending upon the circumstances and facts surrounding that at the time, and I don't believe that you can make a general rule on that.
> Q. It seems to me, at least that after you had acquired a block of stock, a block of the controlling interest, from the insiders or sponsors or managers, no matter how you want to designate them, * * * who was there looking after the other stockholders of the other corporations?
> A. The board of directors.
> Q. But it was usual in each one of the acquisition cases, and I think it was the invariable rule, and you can check that when we take the specific cases, that the individuals whom you just characterized as the board of directors were the very individuals with whom you had made the initial transaction where you acquired a holding in the corporation; isn't that so? * * * They had gotten what they considered the fair price or the adequate price for their holdings, so that they had no pecuniary interest with respect to the future conduct of the investment trust to be acquired. Now, you were doing your job for your stockholders, and these individuals had done their job for themselves, but what body was there which was competent or comparable or sufficiently familiar with the situation to look after the inarticulate and impotent minorities?
> A. Well, every company has a board of directors at any specific time, and that board of directors at that specific time is the elected body by the stockholders to direct and supervise the affairs of the company. How far they must divide their attention between saying, "I am looking after the company as a whole," and saying, "I am looking after or I am here to look after a particular group of my stockholders as against any

Once having obtained control of an investment company, the "fairness of the trade" [29] which the acquiring corporation was willing to make with the minority stockholders of the company to be acquired was entirely in the power of the acquiring corporation. The controlling group was in a position to determine both the price it was willing to pay for the securities of the acquired companies and the terms of the exchange offers to be made to their securityholders. By fixing the market price slightly in excess of the market price of comparable securities, it would induce sales of the acquired companies' securities to itself. The controlling company became substantially the only bidder for the securities. If its bidding caused a rise in the value of the securities, it would withdraw its bids until the market price had receded to the desired level. Of course, the stockholders had the privilege of refusing to accept the offers, and in the case of a merger or consolidation, of exercising an appraisal right, if granted to him by statute and if the existence of the right was known to him.

In the following section the history, activities, and techniques of the more active acquirers of investment companies will be described. Succeeding sections will discuss, specifically, the methods by which control of investment companies and the support or acquiescence of the existing management to the plans of the acquirer were obtained, the techniques and strategies devised to induce acceptance of exchange offers, and the control by the management of the absorption processes of dissolution, merger, and consolidation.

II. HISTORY AND ACTIVITIES OF MAJOR ACQUIRERS

The history of the acquisition activities of Wallace Groves, The Equity Corporation, Atlas Corporation, and the organizers of Fiscal Management Company, Ltd., depicts graphically the consequences to the stockholders of companies in which they achieved a dominant interest. Although others were engaged in similar activities, the methods and techniques used by these individuals and corporations will furnish the bulk of the material which forms the subject matter of this chapter.

A. Wallace Groves

The pyramiding by Wallace Groves of a group of investment companies—Yosemite Holding Corporation, Chain & General Equities, Inc., and Interstate Equities Corporation—has already been de-

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other group of my stockholders," I wouldn't undertake to say in general terms. I think that it depends upon specific facts.

Q. Let us be candid about this, Mr. Odlum. When these arrangements were made—we will take them up individually—they were made under such terms and conditions which, shall I say * * * were certainly not unfavorable to these individuals; isn't that so?

A. I think you are not talking about boards of directors; I think that you are talking about somebody else.

Q. We are talking about the individuals who either had the controlling blocks as managers or who were the sponsors, but the dominant personalities in the picture anyway; isn't that so?

A. Yes; if you will follow through the approaches and the negotiations that we had. I think that you will find that in very few cases did we deal with the board of directors, or did they have anything to do with the negotiations; there might have been a man on the board who had some stock, but it certainly wasn't the negotiations in the average case with directors. I doubt if in many cases the directors even knew about the negotiations until it was closed, and some I know didn't.

[29] See testimony of Mr. Odlum, op. cit., supra, note 28.

scribed in detail elsewhere in this report.[1] At this point, however, the profits made by Mr. Groves in the process of amalgamating these investment companies and the concomitant losses suffered by the stockholders as a result of the passage of control of their corporations to Mr. Groves will be briefly discussed.

In September 1931, when Mr. Groves contracted to acquire control of these three hitherto independent investment companies, their aggregate assets totaled approximately $12,000,000. The major portion of these assets consisted largely of diversified, readily marketable securities of industrial companies. All three investment companies had capital structures consisting of preferred and common stocks. But the total assets of the companies were at most sufficient to cover the liquidating value of their outstanding preferred stocks so that their common stocks possessed little or no asset value. These common stocks, in fact, had only a nominal market value. Nevertheless, Mr. Groves agreed to purchase a controlling block of the common stock of each of these companies.

From Bancamerica-Blair Corporation, the sponsors and managers of Interstate Equities Corporation and Hunter Marston, a director of Interstate Equities Corporation, Mr. Groves purchased 642,517 shares of the common stock of Interstate Equities Corporation.[2] Mr. Groves apparently did not have the funds necessary to pay for this block of stock. In order to complete the transaction he borrowed the necessary funds from Franklin Plan Corporation, an industrial banking corporation controlled by his brother, George Groves.[3] The total purchase price of $963,755.50 paid by Mr. Groves was $687,493.19 above the asset value of these shares.[4] Bancamerica-Blair Corporation and Hunter Marston thus terminated their relationship with Interstate Equities Corporation on these favorable terms. Minority common stockholders were not given an opportunity to dispose of their shares to equal advantage. In fact, neither the minority common stockholders nor the preferred stockholders (who were the real "owners" of the assets of the corporation) were informed of the shift in the management of their corporation until after the event.

The common stock of Interstate Equities Corporation acquired by Mr. Groves, although it had only a nominal asset value, represented working control of the corporation which was immediately useful to Mr. Groves. He had, in the meantime, become obligated to purchase approximately 467,938 shares of the common stock of Chain & General Equities, Inc., or 72% of the total outstanding voting power,

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[1] For a detailed discussion of the activities of Wallace Groves in acquiring control of investment companies, see Ch. II of this part of the report, pp. 181–226.

[2] Public Examination, The Equity Corporation, at 81, and Commission's Exhibit No. 10, pars. 1 and 2. Mr. Groves agreed to make a down payment of $150,000 on a block of 542,517 shares of common stock of Interstate Equities Corporation, purchased at $1.50 a share and to pay the balance in installments on October 2, 5 and 8, 1931 (ibid., id., at 86–7 and Commission's Exhibit No. 94).

[3] Public Examination, The Equity Corporation, at 297, and Commission's Exhibit No. 34, pars. 1, 2, 3, 11.

[4] According to the company's own figures, the Interstate Equities Corporation common stock had a net asset value of 43¢ per share as of November 13, 1931. The 642,517 shares which Mr. Groves was purchasing possessed an aggregate net asset value of $276,282.31. On this basis, therefore, Mr. Groves was paying a premium of $687,493.19 over asset value, or a premium of 249% (id., Commission's Exhibits Nos. 16, 17).

for a total price of $935,876.[5] Mr. Groves was apparently without personal funds with which to complete this purchase. Interstate Equities Corporation which he controlled loaned to him the money needed to complete his purchase of control of Chain & General Equities, Inc.[6] The approximately one million dollars loaned to Mr. Groves by Interstate Equities Corporation was secured only by the stock of Chain & General Equities, Inc., which had an asset value of only 39¢ per share [7] and had an aggregate market value of approximately one-half of the amount of the loan.[8] Interstate Equities Corporation had borrowed the funds it had loaned to Mr. Groves from a bank and had secured such loan by the pledge of "blue chip" securities in its portfolio.[9]

Mr. Groves immediately placed his own nominees upon the board of directors of Chain & General Equities, Inc.[10] Despite the fact

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[5] Op. cit. supra, note 1. The agreement between Mr. Groves and the investment company (i. e., Chain & General Equities, Inc.) dated September 23, 1931, provided that the authorized number of shares of common stock of the company was to be increased and that 470,400 of such shares were to be offered to the company's stockholders at $2 per share (op. cit. supra, note 3, Commission's Exhibit No. 8, par. 7). Mr. Groves undertook to purchase on November 4, 1931, at this price all unsubscribed shares plus any additional shares necessary to give him 51% of the total outstanding voting power (id., Commission's Exhibit No. 8, par. 8). Only 2,462 shares of the new issue of common stock were taken down by the Chain & General Equities, Inc., stockholders, and Mr. Groves was therefore able to purchase 467,938 shares for a total price of $935,876.

[6] Op. cit. supra, note 3, at 118. On the morning of November 4, 1931, Interstate Equities Corporation agreed to purchase from Mr. Groves 469,698 shares of Chain & General Equities, Inc., common stock at $2.00 per share for a total of $939,396. This was the identical block of Chain & General Equities, Inc., stock which Mr. Groves was obligated to buy from Chain & General Equities, Inc. (id., Commission's Exhibits Nos. 8, 11). Delivery to Interstate Equities Corporation was made at 15 Exchange Place, Jersey City, New Jersey, at 11 a. m., the exact time and place at which he was to pick up the block of Chain & General Equities, Inc., common stock from Chain & General Equities, Inc. Mr. Groves agreed to repurchase from Interstate Equities Corporation these shares of Chain & General Equities, Inc. stock within 10 days for $940,479.92 (id., Commission's Exhibit No. 11). Although this transaction took the form of a purchase and repurchase agreement, in effect Interstate Equities Corporation was making a loan to Mr. Groves with the Chain & General Equities, Inc., stock as collateral (id., at 118).

[7] The common stock of Chain & General Equities, Inc., had no asset value, and the 25,533 outstanding shares of the company's $100 par value preferred stock were "under water" to the extent of $22.53 per share plus accrued dividends of slightly more than $4.58 per share or a total of $692,249.20, as of September 30, 1931. Therefore, $692,-249.20 of the $935,876 which Mr. Groves agreed to pay into the treasury of Chain & General Equities, Inc., would have to be allocated to the preferred stock before the common stock would possess any asset value (id., Commission's Exhibit No. 9). The balance of $243,626.80 allocable to the 627,000 shares of common stock which would be outstanding after Mr. Groves met his commitment would give the common stock an asset value of approxiately 39¢ per share (id., at 75–7 and Commission's Exhibit No. 9).

[8] Id., Commission's Exhibit No. 8, par. 19. The over-the-counter market prices for the month-ends of October and November 1931, respectively, were:

	Bid	*Ask*
October	$1	$1¾
November	1¼	2

Bank and Quotation Record, November 6, 1931, p. 82; December 4, 1931, p. 82.

[9] Op. cit. supra, note 3, at 95 and Commission's Exhibit No. 13.

[10] These persons included Wallace Groves himself, Paul H. Byer, Walter S. Mack, Jr., and Frederick Fisher (id., Commission's Exhibit No. 9; and derived from supplementary information supplied the Commission by The Equity Corporation). These persons were placed on the board of directors of Chain & General Equities, Inc. even before Mr. Groves had advanced any money on the contract. Subsequently, 6 other directors (Clifford B. Ewart, Wilfred S. Robinson, Ernest B. Warriner, Waverly Rogerson, William A. Brophy, and Samuel C. Taylor), who were nominees of Wallace Groves, were elected to the board of directors of this investment company.

that the passage of control of Chain & General Equities, Inc., to Mr. Groves had been conditioned upon an agreement on the part of Mr. Groves to maintain the corporation as a diversified investment trust,[11] Mr. Groves, with the approval of his own board of directors immediately "unloaded"[12] upon Chain & General Equities, Inc., all of his holdings (642,517 shares) of the common stock of Interstate Equities Corporation. Mr. Groves was paid $1,325,034 for the Interstate Equities Corporation shares by Chain & General Equities, Inc., or $2.06 a share for stock which had cost him $1.50 a share. On the transaction Mr. Groves realized a net profit of $271,069.72.[13]

Chain & General Equities, Inc., thus acquired a controlling block of the common stock of Interstate Equities Corporation at a cost which was the equivalent of 45% of its then total assets.[14] The common stock of Interstate Equities Corporation had, as has been stated, little or no asset value[15] and had a market value of approximately $650,000.[16] In other words, the shares were purchased by Chain & General Equities, Inc., at a price equivalent to approximately twice their market value.

The funds obtained by Mr. Groves by his sale of the common stock of Interstate Equities Corporation to Chain & General Equities, Inc., enabled him to meet certain personal loans which he had incurred in connection with his acquisition of control of these investment companies.[17] Mr. Groves was also enabled by this sale to meet his contractual obligation to purchase from Yosemite Holding Corporation a controlling block of its common stock.[18] Ultimately, Mr. Groves acquired 327,532 shares of the common stock of Yosemite Holding Corporation at a

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[11] Op. cit. supra, note 3, Commission's Exhibit No. 8, par. 19.

[12] Id., Commission's Exhibit No. 12.

[13] The block of stock of Interstate Equities Corporation had cost Mr. Groves $963,775.50, together with fees, commissions, and expenses aggregating $90,188.78. (Derived from supplementary information supplied the Commission for The Equity Corporation.) In discussing the effect of this transaction in Ch. II of this part of the report, pp. 181–226, it is stated:

> The net effect of these transactions was that almost simultaneously with the payment by Wallace Groves of approximately $936,000 (funds which he "borrowed" from Interstate Equities Corporation) to Chain & General Equities, Inc., for the block of Chain & General Equities, Inc., stock (the block which had been "hypothecated" by Mr. Groves as collateral for the loan to him from Interstate Equities Corporation), Mr. Groves sold to Chain & General Equities, Inc., his block of Interstate Equities Corporation stock for $1,325,034. As a consequence, Mr. Groves almost immediately received back from Chain & General Equities, Inc., not only the aproximately $936,000 in cash that he had paid that company but approximately $400,000 in cash in addition.

[14] Op. cit. supra, note 3, at 99–100 and Commission's Exhibits Nos. 8 and 9.

[15] According to the figures of Interstate Equities Corporation, the common stock had a net asset value of 43¢, so that this block of 642,517 shares of the company had an asset value of $276,282.31 (id., Commission's Exhibits Nos. 16, 17). However, an independent audit by Bayer & Clauson, certified public accountants, as of October 20, 1931, stated that the asset value of the Interstate Equities Corporation common stock was minus 11¢ per share (id., Commission's Exhibit No. 18).

[16] The market value of the common stock of Interstate Equities Corporation at this time was high, 1½; low, ¾; last, ⅞.

[17] For a detailed discussion of the personal loans made by Mr. Groves in this connection, see Ch. II of this part of the report, pp. 181–226.

[18] On October 7, 1931, Wallace Groves had agreed to purchase directly from Yosemite Holding Corporation 282,500 shares of its authorized but unissued common stock at $1 per share for a total of $282,500 (op. cit. supra, note 3, Commission's Exhibit No. 28, par 2). The agreement required an immediate payment of $5,000 and the payment of the balance on November 2, 1931 (id., Commission's Exhibit No. 28, par. 3), when the directors and officers of Yosemite Holding Corporation and at least a majority of the directors of its subsidiary investment company, Joint Investors, Inc., were to resign and the nominees of Mr.

cost of approximately $400,000.[19] Following this acquisition of control of Yosemite Holding Corporation, Mr. Groves caused his nominees upon the board of directors of that corporation [20] to ratify sales by him to Yosemite Holding Corporation of the Chain & General Equities, Inc., common stock which secured the loan to him made by Interstate Equities Corporation.[21] Eventually Yosemite Holding Corporation acquired from or through Wallace Groves a total of 320,907 shares of the common stock of Chain & General Equities, Inc., at a cost of approximately $765,000.[22] In order to provide Yosemite Holding Corporation with some of the funds to effect these purchases from Mr. Groves, Granger Trading Corporation's assets were acquired by Yosemite Holding Corporation in a transaction which will be re-

Groves were to be elected to the vacancies created (Id., Commission's Exhibit No. 28, par. 1 (g) and par. 2). Although the amount of stock to be purchased by Mr. Groves directly from Yosemite Holding Corporation constituted only 43% of Yosemite Holding Corporation's voting stock, it was sufficient to give him working control of the company (id., Commission's Exhibits Nos. 28, par. 1 (a), and 185). This was particularly so in view of the fact that Joint Investor's, Inc., controlled by Yosemite Holding Corporation, in turn held 50,000 shares of Yosemite Holding Corporation common stock or over 7% of the voting power of this company. (Yosemite Holding Corporation held 20,000 shares of the Class A stock and 20,000 shares of the Class B stock of Joint Investors, Inc., representing 41% of the voting power of Joint Investors, Inc. [id., at 738 and Commission's Exhibits Nos. 28, par. 1 (b), and 208; *Moody's Manual of Investments, Banks, etc.*, 1932, p. 2212].) On the same day, October 7, 1931, Mr. Groves had agreed to purchase from Baker, Simonds and Company, one of the sponsors of Yosemite Holding Corporation, 254,394 warrants to subscribe to Yosemite Holding Corporation common stock at 20¢ per warrant for an aggregate of $50,878.80 (op. cit., supra, note 3, at 242–5). Payment for these warrants, which were valueless, was not to be made until November 5, 1931. (Since the Yosemite Holding Corporation common stock had an asset value at the time of 17¢ per share, the warrants were valueless [id., Commission's Exhibits Nos. 28 and 125].)

[19] Mr. Groves' original commitment was to purchase 282,500 shares from Yosemite Holding Corporation for a total of $282,500. On November 6, 1931, he acquired an additional 10,000 shares for $10,000 and by December 2, 1932, he had acquired an additional 35,032 shares in the market and from the company itself. (Derived from supplementary information supplied the Commission for Yosemite Holding Corporation; and op. cit. supra, note 3, at 253.)

[20] Mr. Groves caused the resignation of 8 directors of the 14 members of the board, and their vacancies were filled by Wallace Groves, Clifford B. Ewart, Wilfred S. Robinson, Ernest B. Warriner, William A. Brophy, Samuel C. Taylor, Albert A. Sommerwerck, and Franklin W. Ryan. (Derived from supplementary information supplied the Commission for Yosemite Holding Corporation.) All of these men with the exception of Messrs. Sommerwerck and Ryan had been elected directors of Chain & General Equities, Inc., the day before (op. cit. supra, note 10).

[21] On November 11, 1931, the new board of directors of Yosemite Holding Corporation approved a contract between Yosemite Holding Corporation and Mr. Groves whereby the investment company was to purchase 231,158 shares of the common stock of Chain & General Equities, Inc., or about half of Mr. Groves' obligation to Interstate Equities Corporation to repurchase the 467,938 shares of Chain & General common stock at $2.38 per share, for a total of $550,000 (op. cit. supra, note 3, Commissioner's Exhibit No. 32). In addition, Yosemite Holding Corporation (or Joint Investors, Inc., its controlled company) was granted an option on an additional 125,000 shares of the common stock of Chain & General Equities, Inc., exercisable at the same price until February 1, 1932 (ibid.).

[22] Yosemite Holding Corporation was caused to purchase 89,749 shares of Chain & General Equities, Inc. common stock, at $2.40 per share, from Franklin Plan Corporation (id., Commission's Exhibit No. 33) to which company, in the meantime, Wallace Groves had caused the sale of 236,780 shares of the common stock of Chain & General Equities, Inc. at $2.40 per share with an agreement that Wallace Groves would repurchase these shares of stock at cost within 90 days (id., at 268, 271, 789, and Commission's Exhibits Nos. 19 and 33). On the sale of the Chain & General Equities, Inc., stock to Yosemite Holding Corporation and Franklin Plan Corporation, Mr. Groves made a gross profit of $182,396, that is, $87,684 on stock sold to Yosemite Holding Corporation and $94,712 on stock sold to Franklin Plan Corporation (id., at 267 and Commission's Exhibits Nos. 8, 11, 13).

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lated in more detail later in this chapter.[23] On these sales by Mr. Groves of Chain & General Equities, Inc., stock to Yosemite Holding Corporation, Mr. Groves realized profits of approximately $88,000.[24]

However, Yosemite Holding Corporation, in order to complete these purchases of Chain & General Equities, Inc., common stock, was required to liquidate in excess of 80% of its portfolio of diversified securities.[25] In one day, securities which had cost Yosemite Holding Corporation and Union Investors, Inc., another controlled subsidiary,[26] $508,750.59 were liquidated for proceeds of $321,138.10, or at a loss to the stockholders of $187,612.49.[27] In place of its former portfolio of diversified marketable securities, the greater part of Yosemite Holding Corporation's assets were represented by its holdings of Chain & General Equities, Inc., common stock [28] which had virtually no asset value [29] and had a quoted market value equivalent to approximately one-half of the cost of the stock to Yosemite Holding Corporation.[30]

At the conclusion of Mr. Groves' transactions with these corporations, he personally owned 327,532 shares of the common stock of Yosemite Holding Corporation, acquired at a cost to him of $400,-000.[31] Yosemite Holding Corporation controlled Chain & General Equities, Inc., which in turn controlled Interstate Equities Corporation. In creating this system of companies under his control, Mr. Groves, as a result of his self-dealing with these companies, had derived a profit of $450,000. Thus, in effect, the net cost to Mr. Groves of the acquisition of control of Yosemite Holding Corporation, carrying with it control of Chain & General Equities, Inc., and Interstate Equities Corporation, was nominal, but, as a result thereof, Mr. Groves had placed himself in absolute control of approximately $12,000,000 of assets.[32] In reality these assets were allo-

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[23] See infra, pp. 1302–3 and 1480–5.

[24] See note 1, supra.

[25] Op. cit. supra, note 3, at 791–7.

[26] Id., Commission's Exhibit No. 28. Union Investors, Inc., was a wholly-owned subsidiary investment company of Yosemite Holding Corporation and was later merged with Yosemite Holding Corporation (id., at 799).

[27] Id., at 798–800 and Commission's Exhibit No. 106. Securities costing Yosemite Holding Corporation $269,011.85 had been sold for $150,023.15, a loss of $118,988.70. Securities costing Union Investors, Inc., $239,738.74 had been sold for $171,114.95, a loss of $68,623.79 (Ibid.).

[28] When questioned on this phase of his dealings with Yosemite Holding Corporation, Mr. Groves testified (id., at 796–7) :

> Q. Now, isn't it a fact that * * * "they" [the board of directors of Yosemite Holding Corporation] sold every single security that they had in the portfolio except the Joint Investors stock that they owned and the Chain & General stock that they owned in order for them to raise the cash to buy from you the Chain & General stock?
> A. They sold the greater portion of them.
> Q. * * * Didn't "they" clean out the portfolio to buy the Chain & General stock from you?
> A. I told you they sold a good deal of it, or most all of it. I don't know about it.
> Q. So that on December 31, 1931, they only had Joint Investors stock and Chain & General stock, every share of which came from you, itsn't that so, Mr. Groves?
> A. Yes.

[29] See note 7, supra.

[30] See note 8, supra, for market quotations of common stock of Chain & General Equities, Inc.

[31] See Ch. II of this part of the report Appendix B, p. 781–2.

[32] Net assets of Interstate Equities Corporation were $8,636,431.40 (op. cit. supra, note 3, Commission's Exhibit No. 18). Net assets of Chain & General Equities, Inc., were $1,978,-077.09 (id., Commission's Exhibit No. 9). Net assets of Yosemite Holding Corporation were $1,057,677.65 (id., Commission's Exhibits Nos. 28, 31). Net assets of Granger Trading Corporation were $199,112.68 (id., Commission's Exhibit No. 108).

cable only to preferred stockholders of these companies since the total assets of the companies were less in amount than the liquidating value of their outstanding preferred stocks.[33]

In December 1932, Mr. Groves was instrumental in the creation of The Equity Corporation.[34] In exchange for his controlling holdings of Yosemite Holding Corporation common stock (which, as has been related, also represented control of Chain & General Equities, Inc., and of Interstate Equities Corporation), Mr. Groves acquired a controlling block, or 1,150,000 shares of the common stock of The Equity Corporation.[35] In May of 1933, Mr. Groves sold his holdings of The Equity Corporation common stock to David Milton and his associates for $1,050,000,[36] the entire amount of which represented a profit to Mr. Groves.

In contrast to Mr. Groves' profits as the result of his self-dealing with the assets of these companies, the preferred stockholders of these companies suffered severe losses. Yosemite Holding Corporation, prior to the shift in its control to Mr. Groves, had net assets of $313,960,[37] and possessed a portfolio of diversified securities having a market value of $400,000, equivalent to about 95% of the company's gross assets which at this time were $425,736.29.[38] The assets of the company were sufficient to pay each holder of preferred stock the $51 per share to which such share was, by the company's charter, entitled to receive in the event of its liquidation.[39] At the conclusion of Mr. Groves' stewardship of the corporation, almost all of the company's assets had been frozen into its holdings of the common stock of Chain & General Equities, Inc., which it had acquired from Mr. Groves.[40] As at December 31, 1933, the net assets of Yosemite Holding Corporation had declined to only $3,138.60, evaluating its investment in Chain & General Equities, Inc., at its liquidating

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[33] See supra.

[34] The Equity Corporation was organized on December 7, 1932, by Mr. Groves and Chase Donaldson under the laws of Delaware as an investment company of the general management type (op. cit. supra, note 3, Commission's Exhibit No. 33). Mr. Donaldson and his associates, including Herbert R. Anderson, W. F. Best, R. S. Elliot, Jr., Alfred M. Elsesser, Kenneth S. Gaston, and Eliot Sharp (Public Examination, Allied General Corporation, at 5296; op. cit. supra, note 3, Commission's Exhibits Nos. 495 and 496), at this time controlled Allied General Corporation, a company then engaged primarily in the distribution of securities (op. cit. supra, note 3, at 7830, 7848, 7852). Wallace Groves at this time controlled Yosemite Holding Corporation through a personal holding company, Compania Montana (Public Examination, Phoenix Securities Corporation, at 6036–40).

[35] On December 9, 1932, two days after the organization of The Equity Corporation, Mr. Groves and Mr. Donaldson and his associates turned into the new corporation their control holdings of Yosemite Holding Corporation and Allied General Corporation, respectively, in return for 1,650,000 shares of The Equity Corporation common stock. In addition, $50,000 in cash was supplied The Equity Corporation in return for 50,000 shares of The Equity Corporation common stock. Out of the 1,700,000 shares thus issued, constituting all of The Equity Corporation's then outstanding stock, Mr. Groves received 1,150,000 shares for his control holdings of Yosemite Holding Corporation stock and Chase Donaldson and his associates received 500,000 shares for the Allied General Corporation holdings and 50,000 shares for the cash. See Ch. II of this part of the report, pp. 181–226.

[36] Op. cit. supra, note 3, Commission's Exhibit No. 837.

[37] Id., at 1367 and Commission's Exhibits Nos. 28, 37.

[38] Id., Commission's Exhibits Nos. 28, 185.

[39] There were outstanding 4,822 shares of preferred stock (id. Commission's Exhibit No. 31). The outstanding common stock of Yosemite Holding Corporation at this time had an asset value of approximately 17 cents per share (ibid.).

[40] See supra, pp. 1035–6.

value.[41] The company virtually had no portfolio of marketable securities and the asset value of its outstanding preferred stock had declined to 43 cents a share.[42]

Similar losses were suffered by the preferred stockholders of Chain & General Equities, Inc. As a result of the purchase by Chain & General Equities, Inc., of Mr. Groves' holdings of the common stock of Interstate Equities Corporation, the liquidity of Chain & General Equities, Inc.'s, assets had virtually disappeared. As at September 30, 1931, the company had net assets (at market or estimated fair value) of $1,978,077.09, of which $1,917,547.99, or 97%, was invested in a diversified list of marketable securities.[43] As at June 30, 1933, however, the net assets of Chain & General Equities, Inc., had decreased to $1,272,942.20, of which only $511,858.13, or 40%, were invested in diversified securities.[44] Over 60% of the company's assets were invested in the common stock of Interstate Equities Corporation, which had an asset value of $494,827, but which had originally cost Chain & General Equities, Inc., $1,690,986.22.[45] This shift in the investment policy of Chain & General Equities, Inc., was accompanied by a decline in the asset value of the outstanding preferred stock of the company. As at September 30, 1931, the preferred stock with a par value of $100 per share had a net asset value of $77.47 per share before the deduction of accrued and unpaid dividends of $4.58 per share.[46] By June 30, 1933, the asset value of the preferred stock of Chain & General Equities, Inc., had shrunk to $69 a share[47] before the deduction of unpaid accrued dividends of $13.87½ per share.

Even this asset value was never realized by the bulk of the preferred stockholders of Chain & General Equities, Inc. The Equity Corpora-

[41] Op. cit. supra, note 3, Commission's Exhibit No. 843 and derived from supplementary information supplied the Commission for The Equity Corporation.

[42] Ibid. A letter written on July 27, 1932, by Edward R. Tinker, the first president of Interstate Equities Corporation, to Wallace Groves states with reference to the practice of using the assets of acquired investment companies to purchase controlling blocks of the negative asset value common stocks of other investment companies at prices in excess of the market value of such stocks (Public Examination, Interstate Equities Corporation, Commission's Exhibit No. 24):

> * * * The premium that is being paid for control of investment trusts today is based on the same theory as the man who in a panic pays a premium for gold with the return to normalcy, this premium will rapidly disappear. Therefore from any viewpoint it is a transitory condition and is not the viewpoint upon which one should base the operation of an investment trust, and this is particularly so inasmuch as in the operation of this premium for control theory a minority or preferred stock interest receives in practice no benefit of the premium.
>
> In my own judgment, it is only a question of time when any policy which might imply the handling of preferred stockholders' and minority stockholders' funds, based on the above-mentioned theory of premium for control, will be exposed to the merciless criticism of public investigation * * *.

[43] Op. cit. supra, note 3, Commission's Exhibit No. 9.

[44] Id., Commission's Exhibit No. 235–L. In the valuation of total assets, investments in securities were taken at market or estimated fair value. The investments in the common and preferred stocks of Interstate Equities Corporation were taken at asset value, $494,827. During the period from October 1, 1931, through June 30, 1933, there was returned to Chain & General Equities, Inc., preferred stockholders $172,432.25 by the repurchase of 7,083 shares of Chain & General Equities, Inc., preferred stock, which had originally been issued for $708,300 (id., Commission's Exhibits Nos. 9, 19, 235–K, 235–L, 843).

[45] Id., Commission's Exhibit No. 235–L.

[46] Id., Commission's Exhibit No. 9.

[47] Id., Commission's Exhibits Nos. 843, 235–L. In making this computation, Chain & General Equities, Inc.'s holdings of the preferred and common stock of Interstate Equities Corporation were figured at liquidating value (ibid.).

tion, which acquired control of the company in December of 1932, almost immediately entered upon a campaign to acquire the preferred stock of the company through the medium of exchange offers of The Equity Corporation's securities having an asset value substantially less than the asset value of the Chain & General Equities, Inc., preferred stock. The stockholders of Chain & General Equities, Inc., who accepted these exchange offers or who accepted The Equity Corporation's securities issued on the merger of their company with The Equity Corporation suffered aggregate losses in asset value of approximately $263,521.17.[48]

The investment policy of Interstate Equities Corporation was not altered by Mr. Groves until the sale of his controlling shares in The Equity Corporation to David M. Milton. The very process of the passage of control of The Equity Corporation to Mr. Milton involved a sharp change in the investment policies of Interstate Equities Corporation. As will be seen later, the acquisition of additional investment companies by The Equity Corporation in the course of its program of acquiring investment companies under the management of Mr. Milton was financed to a large extent by Interstate Equities Corporation.[49] Eventually Interstate Equities Corporation, through the technique of the exchange offer and the legal process of merger was absorbed by The Equity Corporation.[50] The acceptance of the exchange offers resulted in an aggregate loss in asset value to the preferred stockholders of Interstate Equities Corporation of approximately $293,603.[51]

B. The Equity Corporation

The Equity Corporation was organized on December 7, 1932, under the laws of the State of Delaware as an investment company of the general management type.[52] The company was sponsored jointly by Wallace Groves, Chase Donaldson, Kenneth Gaston, and others.[53]

The authorized capital stock of The Equity Corporation at the time of incorporation consisted of a convertible preferred stock entitled on liquidation of the company to a preference in assets to the extent of $50 per share, entitled to cumulative dividends of $3

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[48] See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, p. 208 (note 27).

[49] See infra, pp. 1043–6.

[50] Op. cit., supra, note 3, Commission's Exhibit No. 838.

[51] Op. cit., supra, note 48.

[52] Op cit., supra, note 3, Commission's Exhibit No. 831. From the outset it was the purpose of the sponsors of The Equity Corporation to cause the company not only to function as an investment medium, but also to engage in the acquisition of control of other investment companies and to merge these companies with The Equity Corporation. Chase Donaldson testified (id., at 7858–9):

Q. * * * What did you hope to accomplish, and what were the plans of Mr. Groves and yourself when you had these discussions which finally culminated in the formation of The Equity Corporation?

A. Well, in December of 1932 the situation still existed in a substantial number of management investment company stocks where they were selling at discounts from their asset value or where the leverage factor might prove interesting in the event of a recovery; and our company, Allied General, had not only been familiar with the experience of the United Founders group but the experience of the Atlas Corporation, and we had made very exhaustive studies and, I think, perhaps were considered authorities on leverage and management investment companies.

We thought over a period of two or three years, granted industrial recovery, that the purchase or acquisition of common or preferred stocks at discounts, and that

per annum and convertible at any time into 10 shares of common stock; and a common stock. Both the preferred and common stock had voting rights.[54]

As of June 30, 1937, there were outstanding 269,467.8 shares of the preferred stock and 4,828,589 22/48 shares of the common stock of The Equity Corporation.[55]

On December 9, 1932, two days after the organization of The Equity Corporation, Messrs. Groves and Donaldson and his associates turned in to the Equity Corporation their control holdings of Yosemite Holding Corporation, an investment trust holding company,[56] and Allied General Corporation, respectively, in return for 1,650,000 shares of The Equity Corporation common stock.[57] An affiliated company supplied The Equity Corporation with $50,000 in cash.[58] The aggregate asset values of the securities acquired by The Equity Corporation from Mr. Groves and Mr. Donaldson

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leverage stock, even though a premium should be paid for it, would ultimately result in a profit.

I felt * * * speaking now for myself and not for Mr. Groves—that there was an opportunity to build a financial institution which would be the same sort of an Institution as insurance companies, and that we would be able to administer the funds of a substantial number of investors and provide them, not with dozens of illiquid markets of their securities, but with one or two securities.

I further felt that the operating expenses of individual companies still at that time were very high with respect to the assets that were managed, perhaps because of the fact that they were individual companies.

And I felt that The Equity as a vehicle could reduce the operating expenses, could provide investors with a more ready market for their securities, and could secure enough talent to administer these combined funds on an institutional rather than on a haphazard basis.

[53] Public Examination, Allied General Corporation, at 5296, and Commission's Exhibits Nos. 495, 496.

[54] Op. cit. supra, note 3, Commission's Exhibit No. 715.

[55] Annual Report, The Equity Corporation (1937). None of the preferred and only about 200,000 shares of the common had been issued for cash. The Corporation received $242,511.25 for this common stock. The preferred stock and the remainder of the common stock issued subsequent to the original issuance of 1,700,000 shares to the Groves and Donaldson interests when the company was first organized had been issued pursuant to the exchange offers and statutory mergers of other companies into The Equity Corporation (op. cit. supra, note 3, at 8346–50, and Commission's Exhibit No. 997A).

[56] Mr. Groves controlled Yosemite Holding Corporation through a personal holding company, Compania Montana, a Panama corporation. By November 16, 1931, Mr. Groves had acquired 292,500 shares of Yosemite Holding Corporation common stock for $292,500. Commission fees, and other expenses increased the cost to $363,356.29. On December 15, 1931, Mr. Groves sold these shares for $150,000 to Wagegro Corporation, a Delaware Corporation controlled by Mr. Groves. The sale, admittedly made to establish a loss for tax-avoidance purposes, offset the net profit which Mr. Groves had realized on November 4, 1931, from the sale of 642,517 shares of the common stock of Interstate Equities Corporation to Chain & General Equities, Inc. Shortly thereafter Wagegro Corporation sold the Yosemite Holding Corporation common stock to Compania Montana, a Panama corporation wholly owned by Mr. Groves (Public Examination, Phoenix Securities Corporation at 6036–40).

Between November 16, 1931, and December 9, 1932, Mr. Groves or his affiliated companies purchased from Yosemite Holding Corporation and in the open market additional shares of the common stock of Yosemite Holding Corporation until their total holdings aggregated 327,532 shares, representing 50.1% of the voting power of the company (op. cit. supra, note 3, at 285, and Commission's Exhibits Nos. 185, 766 (p. 10) and 843; and derived from supplementary information supplied the Commission for The Equity Corporation).

[57] Wallace Groves received 1,150,000 shares and Chase Donaldson and his associates received 500,000 shares of the common stock of The Equity Corporation. (See Ch. II of this part of the report, pp. 181–226.)

[58] In return for this $50,000 in cash, Chase Donaldson and his associates received 50,000 shares of the common stock of The Equity Corporation.

amounted to approximately $250,000,[59] so that The Equity Corporation began operations with assets of $300,000. The gross assets subject to the control of The Equity Corporation, however, amounted to approximately $6,500,000, represented chiefly by the assets of Interstate Equities Corporation and Chain & General Equities, Inc., the two investment companies controlled by Yosemite Holding Corporation.[60] In return for these assets, The Equity Corporation issued 1,700,000 shares of its common stock, of which 1,150,000 shares, representing control, went to Mr. Groves.[61]

The avowed purpose for the formation of The Equity Corporation was the eventual acquisition by the legal processes of dissolution, merger, or consolidation of the assets of its subsidiaries and of other investment companies.[62]

In May 1933, six months after the formation of The Equity Corporation, David M. Milton, then a partner in the New York law firm of Satterlee and Canfield, concluded negotiations with Mr. Groves for the purchase of 1,000,000 shares of the common stock of The Equity Corporation for $900,000, and an option to purchase an additional 50,000 shares for $150,000.[63]

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[59] The Allied General Corporation stock turned in to The Equity Corporation had an asset value of about $250,000. The Yosemite Holding Corporation stock had no asset value. Thus on formation The Equity Corporation's total assets, on the basis of liquidating value, were worth about $300,000. Yosemite Holding Corporation, however, had voting control of Chain & General Equities, Inc., which in turn had voting control of Interstate Equities Corporation. The gross assets of these companies, together with the gross assets of Allied General Corporation aggregating approximately $6,500,000, were thus brought under the control of The Equity Corporation (op. cit. supra, note 3, at 7849–50, 11983–6, 11989–91, and Commission's Exhibits Nos. 766, 831, 1173).

[60] Id., at 7849–50, 11953–6, 11989–91, and Commission's Exhibits Nos. 766, 831, 1173.

[61] See note 57, supra.

[62] Statements of this purpose of organizing The Equity Corporation were embodied in the circulars sent to prospective stockholders. The following are examples: "The Equity Corporation was incorporated * * * to acquire the securities and facilitate the consolidation of other investment companies" (op. cit. supra, note 3, Commission's Exhibit No. 1173, circular dated December 30, 1932); "The Equity Corporation * * * was incorporated * * * to provide for the * * * acquisition and consolidation of existing investment companies" (reply to the Commission's questionnaire for The Equity Corporation, Pt. 1, Exhibit K–2, circular dated March 14, 1932); "One objective of its incorporation was to bring about the consolidation of several other investment trusts into one corporation or into a coordinated, controlled group—an objective gradually being reached" (id., Exhibit K–3, circular dated April 21, 1933).

[63] Op. cit. supra, note 3, Commission's Exhibit No. 718. The contract for the purchase of this common stock of The Equity Corporation was made between Compania Montana, the personal holding company of Mr. Groves, and Oceanic Life Insurance Co., Ltd., a company indirectly controlled by Mr. Milton and Mr. Huntington by virtue of their indirect control of Consolidated Funds Corporation of New York, which corporation had a controlling interest in Underwriters Equities, Inc. The latter corporation, in turn, was the owner of 442 shares out of a total authorized issue of 500 shares of the Oceanic Underwriters Equities, Inc., to which it had subscribed under contract of May 17, 1933. Underwriters Equities, Inc., had agreed to pay $700,000 to the Oceanic Life Insurance Co. for those 442 shares, but as of May 19, 1933, had not done so.

On May 19, 1933, Underwriters Equities, Inc., entered into a contract with Interstate Equities Corporation whereby the latter contracted to purchase 56,410 shares of the capital stock of American Colony Insurance Co. at $12 a share and 41,601.7 shares of the capital stock of Colonial States Fire Insurance Co. at $5.24 per share, representing a total purchase price of $894,912.90. The stock holdings in those two insurance companies had previously comprised substantially all of the assets of Underwriters Equities, Inc. On May 26, 1933, one week after Interstate Equities Corporation had bought these insurance stocks from Underwriters Equities, Inc., the latter corporation transferred $700,000 of the $894,912.90 it had received from Interstate Equities Corporation to Oceanic Life Insurance Co., Ltd., as payment for the Oceanic Life Insurance Co., Ltd., stock for which it had subscribed on

Because Mr. Milton was either unwilling or unable to advance the necessary cash, Mr. Groves and he devised a plan whereby Interstate Equities Corporation, the subsidiary of The Equity Corporation, was to supply the funds needed by Mr. Milton to purchase control of The Equity Corporation from Mr. Groves.[64] It was contemplated that Interstate Equities Corporation would purchase from Underwriters Equities, Inc., a company controlled by Mr. Milton and his associates, 56,410 shares of American Colony Insurance Company at $12 a share and 41,601.7 shares of the capital stock of Colonial States Fire Insurance Company at $5.24 per share, representing a total purchase price of $894,812.90.[65] With this money the Milton interests would be able and did make the payment of $900,000 to Mr. Groves.[66]

These blocks of stock of the two insurance companies which were to be sold to Interstate Equities Corporation had been accumulated by Underwriters Equities, Inc., to a substantial extent by the use of the funds of Atlantic and Pacific International Corporation, an investment company, control of which had been acquired by Mr. Milton and Mr. Huntington in August of 1932 without the expenditure of any of their own funds.[67] The personal investment of Messrs.

May 17, 1933. At approximately the same time Underwriters Equities, Inc., acquired the remaining 58 shares of the capital stock of Oceanic Life Insurance Co., Ltd., in exchange for 500 shares of stock of the American Colony Insurance Co., valued at $5,010. It should be noted that while these remaining 58 shares of Oceanic Life Insurance Co., Ltd. stock were purchased for $5,010, or $86.38 per share, Underwriters Equities, Inc. at approximately the same time had subscribed for 442 shares of Oceanic Life Insurance Co., Ltd. stock for $700,000, or what amounted to $1,583.71 a share. The discrepancy in these purchase prices for the same stock is not explained. The monies and securities thus received from Underwriters Equities, Inc. in payment for its stock represented at that point all the assets of the Oceanic Life Insurance Co., Ltd. On May 26, 1933, the same day on which the transfer of $700,000 from Underwriters Equities, Inc., to Oceanic Life Insurance Co., Ltd., took place, the latter company purchased from Compania Montana, wholly owned by Wallace Groves, 1,000,000 shares of common stock of The Equity Corporation for $900,000, of which $700,000 was paid in cash and the balance of $200,000 by delivery of a note of Oceanic Life Insurance Co., Ltd., secured by a pledge of 200,000 shares of the stock purchased. *In the Matter of The Equity Corporation*, 2 S. E. C. 675 (1937).

[64] Mr. Milton testified that one of the conditions of his purchase of The Equity Corporation stock from Mr. Groves was that Interstate Equities Corporation purchase the insurance stock from the Milton interests. Mr. Milton claimed that the reason for the purchase was that the insurance stocks were a "very valuable" investment over which the new management wished The Equity Corporation to secure control (op. cit. supra, note 3, at 7906). Mr. Milton denied, however, that at the time he sold the insurance stocks to Interstate Equities Corporation he had committed himself to Mr. Groves to use the proceeds of that sale to buy Mr. Groves' interest in The Equity Corporation (id., at 7917). Nevertheless, on May 19, 1933, the day on which Interstate Equities Corporation purchased the insurance stocks from Underwriters Equities, Inc., and a week before Mr. Groves actually transferred control to the Milton interests, Mr. Groves knew that Mr. Milton was "going to buy him out." (See minutes of the meeting of directors of Interstate Equities Corporation held on May 19, 1933; id., Commission's Exhibit No. 110.)

[65] See note 63, supra.

[66] Ibid. Mr. Milton testified on this phase of the transaction as follows (op. cit. supra, note 31, at 7905–6):

> Q. * * * the situation was that on May 19, 1933, Underwriters Equities sells to Interstate Equities, at the time Wallace Groves indirectly controls that company * * * nine hundred thousand dollars worth of insurance stock, and one week later it takes the money it got for the insurance stocks and buys a million dollars worth of stock of Equity Corporation from Mr. Wallace Groves? Isn't that so?
>
> A. That is correct.
>
> Q. * * * The cash that was used by this interest to get control of The Equity Corporation was money that came from a subsidiary of The Equity Corporation? Isn't that so?
>
> A. I think that is correct.

[67] See infra, pp. 1120–38.

Milton and Huntington and their families in the insurance companies stock held by Underwriters Equities, Inc., did not exceed $175,000.[68] On this investment of $175,000 the Milton and Huntington interests were enabled to acquire and maintain control of The Equity Corporation whose gross assets by December 31, 1935, according to statements included in the annual report for that year, had increased to $24,710,048.27.[69] The gross assets subject to the control of The Equity Corporation as at December 31, 1935, were approximately $205,000,000.[70]

1. CHANGE IN INVESTMENT POLICIES OF INTERSTATE EQUITIES CORPORATION

It will be remembered that Interstate Equities Corporation had not been changed by Mr. Groves in its operation as a diversified investment company. The contemplated purchase of the insurance stocks by Interstate Equities Corporation ran counter to the investment policy to which it had previously adhered. On December 22, 1932, in its report to the stockholders, the management had emphasized that Interstate Equities Corporation would invest the major portion of its assets in stocks chosen from an "Approved List" and that not more than 10% of its net assets was to be invested in any stock on the "List," and that no more than 10% of the outstanding capital stock of any company on the "List" would be purchased.[71] Funds not employed in purchasing securities on the "List" could be invested in "securities of investment companies, whether or not for the purpose of obtaining control." [72]

The investment in the securities of the insurance companies would have constituted a threefold violation of Interstate Equities Corporation's investment policy. First, the purchase price of approximately $900,000 represented more than 10% of Interstate Equities Corporation's net assets, since its gross assets as of June 30, 1933, totaled only $6,340,426.30.[73] Second, the 56,862 shares of American Colony Insurance Company and the 40,700 shares of Colonial States Fire Insurance Company to be purchased represented 75% and 66%, respectively, of the outstanding capital stocks of those companies.[74] Finally, the stocks of the insurance companies were admittedly not on the "Approved List." [75] The purchase would be permissible only if that portion of the company's policy allowing investments in securities of "investment companies," even for the purpose of obtaining control, could be construed to cover investments in insurance companies.

On May 19, 1933, a special meeting of the directors of Interstate Equities Corporation was apparently called to devise some construc-

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[68] Ibid.

[69] Op. cit. supra, note 3, Commission's Exhibit No. 850.

[70] Id., Commission's Exhibits Nos. 850, 862; Report of American General Corporation for the period ended December 31, 1935. These assets were comprised of the funds of 14 investment companies and 7 insurance companies.

[71] Op. cit. supra, note 3, Commission's Exhibit No. 719.

[72] Ibid.

[73] Id., Commission's Exhibit No. 722.

[74] Ibid.

[75] Ibid.

tion of the restrictions on the company's investment policy to permit the Milton interests to sell the insurance companies to the investment company upon the ground that the insurance companies which had reinsured their risks were in effect investment companies.[76] The board of directors approved the purchase of $900,000 worth of stocks of the insurance companies, and announced the prospective sale of Mr. Groves' holdings of the common stock of The Equity Corporation to the Milton interests.[77]

The new management, representing the Milton interests, immediately proceeded to modify the investment policy of Interstate Equities Corporation, and stated in its report to stockholders of June 1933:[78]

The Board of Directors deemed it desirable to interpret and modify by restatement the first paragraph of Investment Policy Resolutions reported to you under date of January 19, 1933, so that it shall read as follows:

"The Corporation shall maintain a General Investment Portfolio which shall consist of common stocks selected from an Approved List of Common Stocks as revised from time to time by the Board of Directors, of preferred stocks, bonds, and/or cash; no investment of any portion of the assets of the corporation may at any time be made in any security or property other than securities eligible for the General Investment Portfolio, unless at the time of such investment, the General Investment Portfolio shall include not less than fifty-one percent (51%) of the Corporation's assets (exclusive of investments in companies controlled directly or indirectly by the Corporation and/or its subsidiary and/or affiliated companies) taken at market value, or in the absence thereof, at estimated fair value."

The effect of this modification was to exempt from the requirement of making investments in conformity with the "Approved List," any "Investments in companies controlled directly or indirectly by the Corporation and/or its subsidiary and/or affiliated companies."[79] The new policy forbade investments in securities not on the "Approved List," unless the general investment portfolio comprised at least 51% of the total assets of Interstate Equities Corporation. However, in determining the ratio of the value of the securities in the general investment portfolio to the company's total assets, investments in controlled, subsidiary, or affiliated companies were not to be considered. Thus, it was entirely possible, within the new investment policy, to invest all, or the major part of, Interstate Equities Corporation's assets in controlled companies, before purchasing securities on the "Approved List." Interstate Equities Corporation was now in a position to abandon its function as a medium through which the small investor could acquire an interest in a widely diversified list of securities and become a vehicle for the expansion of its parent, The Equity Corporation, through the acquisition of controlling or substantial interests in other companies.

The first step in that direction, the acquisition of control of American Colony Insurance Company and Colonial States Fire Insurance Company on May 19, 1933, for almost $900,000, has already been indicated.[80] Five weeks later, on July 1, 1933, Interstate Equities Cor-

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[76] Id., at 7940 and Commission's Exhibit No. 110.

[77] Id., Commission's Exhibit No. 110.

[78] Id., Commission's Exhibit No. 722.

[79] Ibid.

[80] See supra, pp. 1042–3.

poration accepted a $500,000 participation in a syndicate, headed by The Equity Corporation, looking toward the acquisition of a "substantial interest" in the United Founders Corporation, the top holding company in another system of investment trusts and investment companies.[81] The acquisition by The Equity Corporation of control of United Founders Corporation will be related in detail later in this chapter.[82] Two months later, on September 5, 1933, The Equity Corporation caused Interstate Equities Corporation to make a still larger investment in another insurance company. The Equity Corporation headed a syndicate formed to create a corporation, General American Life Insurance Company, to acquire and manage the assets of Missouri State Life Insurance Company.[83] Interstate Equities Corporation advanced $1,500,000 out of total participations aggregating $1,750,000.[84]

The change in the investment policy of Interstate Equities Corporation had transformed the investment company from an organization engaged primarily in investment and reinvestment in a list of varied securities into a company engaged in the acquisition of substantial or controlling stocks of other corporations. Concentration of investments had taken the place of diversification. On March 31, 1933, approximately seven weeks before the Milton interests attained control of Interstate Equities Corporation, the trust had $3,724,054 out of total gross assets of $4,344,802.42, or 85.7% of its assets, invested in diversified securities and cash.[85] Only $597,750, or 14.3% of its total gross assets, was invested in a single specialized situation.[86] By the end of September 1933, after four months under the new management, Interstate Equities Corporation had $2,451,-239.23 out of total gross assets of $5,995,255.89, or only 40.9% in diversified securities and cash, while $3,333,963.24, or 55.6% of the trust's total gross assets, was invested in four specialized situations.[87]

In the process of transformation, Interstate Equities Corporation was compelled to liquidate a large portion of its portfolio to obtain the cash necessary to meet its $1,500,000 participation in the General American Life Insurance Company Syndicate. On this point, Mr. Milton testified as follows:[88]

A. On September 5, they [Interstate Equities Corporation] had $298,000 in cash, so they had to raise an additional $1,210,000 to meet this commitment.

Q. You did sell, as far as this transaction is concerned, $1,300,000 of your marketable securities.

A. Approximately for that purpose.

It is apparent that The Equity Corporation, in causing the investment policy of Interstate Equities Corporation to be changed, desired

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[81] Op. cit. supra, note 3, Commission's Exhibit No. 804.

[82] See infra, pp. 1138–42.

[83] Op. cit. supra, note 3, Commission's Exhibit No. 723.

[84] Ibid.

[85] Id., Commission's Exhibit No. 720.

[86] This investment was in Distributors Group, Inc. (Ibid.)

[87] Id., Commission's Exhibit No. 723. The specialized situations were (1) an investment of $418,425 in Distributors Group, Inc., (2) a participation of $515,489 in United Founders Corporation Syndicate (3) an investment of $900,049 in controlled insurance companies, and (4) a participation of $1,500,000 in the General American Life Insurance Company syndicate.

[88] Id., at 7967–8.

to employ the approximately $6,000,000 of assets of Interstate Equities Corporation[89] to facilitate its own expansion program. The Equity Corporation itself lacked the funds necessary to carry on such a campaign. On June 30, 1933, The Equity Corporation, on an unconsolidated basis, possessed assets of approximately $170,000 and owned no securities other than the capital stocks of its controlled companies.[90] Although Mr. Milton conceded that the funds of Interstate Equities Corporation were utilized in carrying out the expansion program of The Equity Corporation, he refused to admit that he had deliberately purchased control of The Equity Corporation with a view to obtaining control of Interstate Equities Corporation's assets for that purpose. Mr. Milton testified:[91]

Q. I am trying to find out where you hoped to get the money, to effect this [expansion program]?

A. The investments were made by Interstate.

Q. So that when you bought The Equity Corporation from the Wallace Groves interests you intended to use the money of the subsidiary in connection with this campaign; isn't that so?

A. There was no intention at the time of making some of these investments.

Q. But you ultimately did make them.

A. That is a different story.

Q. Of course, Mr. Milton, doesn't it become apparent that one of the reasons that the $1,000,000 was paid for the Equity Corporation's stock was that you could take the Interstate Equity's money and put them into those situations, and it gave you control of that $6,000,000; isn't that so?

A. That isn't the purpose.

Q. It is just a fortuitous circumstance that after you got control that all of the money for the big transactions of The Equity Corporation came out of Interstate Equities and not one nickel came out of The Equity Corporation?

A. It is not a fortuitous circumstance.

Ultimately, the preferred stockholders of Interstate Equities Corporation (who were the real "owners" of its assets since the preferred stock was "under water" and the assets were insufficient to cover the liquidating value of the preferred stock), as the result of their acceptance of the exchange offers of The Equity Corporation and the merger of their corporation with The Equity Corporation, suffered an aggregate loss in asset values of $1,350,522.[92]

As has been indicated, The Equity Corporation was designed from its inception to function not only as an investment medium but as a vehicle for the acquisition and consolidation of its existing subsidiaries and of other investment companies.[93] Under the management of Mr. Milton the corporation underwent a period of rapid growth, its gross assets increasing within three years from $311,926.35 to $24,710,048.27.[94] Similarly, the gross assets subject to its control mounted from $6,225,789.66 to $205,000,000.[95] This growth repre-

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[89] Id., Commission's Exhibit No. 722.

[90] Id., at 7963.

[91] Id., at 7964.

[92] See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, p. 206; and op. cit. supra, note 3, Commission's Exhibit No. 775.

[93] See note 62, supra.

[94] Op. cit. supra, note 3, Commission's Exhibits Nos. 845, 850.

[95] Id., Commission's Exhibits Nos. 845, 850. 862.

sented for the most part the absorption of the bulk of the assets of seventeen publicly held companies,[96] in addition to the four investment companies under the control of The Equity Corporation at the time of its organization.[97] Reflecting this development was the increase in The Equity Corporation's outstanding capital stock. Including the initial issue of 1,700,000 shares of common stock, there were outstanding, at December 31, 1935, 274,365.4 shares of preferred stock and 4,959,885 22/48 shares of common stock.[98]

The growth of The Equity Corporation was marked by the making of approximately 50 exchange offers to the security holders of 13 of these 21 companies.[99] Mergers accounted for the absorption by The Equity Corporation or by its controlled subsidiaries of the assets of nine of these 21 companies;[100] four companies were dissolved;[101] and eight more were consolidated into a subsidiary of The Equity Corporation.[102]

The procedure by which the development of The Equity Corporation was accomplished involved basically three steps. First, The Equity Corporation would acquire voting, or at least working control of the company ultimately to be absorbed.[103] This step would be fol-

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[96] These companies included the following 11 investment companies: American, British & Continental Corporation, American and Continental Corporation, American Founders Corporation, American & General Securities Corporation, Eastern Shares Corporation, International Securities Corporation of America, Reliance International Corporation, Reliance Management Corporation, Second International Securities Corporation, United Founders Corporation, United States & British International Company, Ltd.; and the following 6 insurance companies: American Colony Insurance Company, American Merchant Marine Insurance Company, Colonial States Fire Insurance Company (old), General Alliance Corporation, Majestic Fire Insurance Company, North Star Insurance Company (id., Commission's Exhibit No. 796).

[97] These 4 companies were: Allied General Corporation, Chain & General Equities, Inc., Interstate Equities Corporation, and Yosemite Holding Corporation (id., Commission's Exhibit No. 845).

[98] Id., Commission's Exhibit No. 850.

[99] Id., Commission's Exhibits Nos. 839 and 840. This total includes the offers made to the stockholders of Colonial States Fire Insurance Company and Majestic Fire Insurance Company of New York after they had been merged, by successive steps, into American Colony Insurance Company. The exchange offer made to stockholders of Oceanic Fire Insurance Company of New York which had been merged into American Colony Insurance Company in 1931 before The Equity Corporation had been organized, has not been included (ibid.).

[100] These companies were Chain & General Equities, Inc., Interstate Equities Corporation, Reliance International Corporation, American, British & Continental Corporation, Majestic Fire Insurance Company, Colonial States Fire Insurance Company (old), American Merchant Marine Insurance Company, American Colony Insurance Company, and North Star Insurance Company (Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, p. 205).

[101] These 4 companies were: Yosemite Holding Corporation, Eastern Shares Corporation, Allied General Corporation and General Alliance Corporation (ibid.).

[102] These 8 companies were United Founders Corporation, American Founders Corporation, American and Continental Corporation, American & General Securities Corporation, International Securities Corporation, Second International Securities Corporation, United States & British International Company, Ltd., and Reliance Management Corporation (ibid., and op. cit. supra, note 3, Commission's Exhibits Nos. 796, 812, 821, 838, 1183).

[103] For example, The Equity Corporation owned directly securities representing 50.5% of the voting power of Yosemite Holding Corporation (op. cit. supra, note 3, Commission's Exhibit No. 843, and the reply to the Commission's questionnaire for Yosemite Holding Corporation, Pt. I, Exhibits A. B.); 52% of the voting power of Allied General Corporation (op. cit. supra, note 3. Commission's Exhibit No. 843, and the reply to the Commission's questionnaire for Allied General Corporation, Pt. I, Exhibits A, B); 58.9% of the voting power of Eastern Shares Corporation (op. cit. supra, note 3, Commission's Exhibits Nos. 113. 128, 784–A, 843); and 42.6% of the voting power for general corporate purposes of Reliance International Corporation (id., Commission's Exhibits Nos. 143, 843. The pre-

lowed in almost all instances by an exchange offer of securities of The Equity Corporation for securities of the other company. In this manner, The Equity Corporation would usually acquire sufficient stock, when coupled with its original holdings, to enable it to effect a dissolution, merger or consolidation of the controlled company. Finally, The Equity Corporation would complete the absorption of the assets of its subsidiaries by effecting their dissolution or their merger or consolidation with itself.

The Equity Corporation's technique of obtaining control of other companies was characterized by the fact that in all instances the original control block was purchased either directly from the management or from a large institutional holder. In no case was such control block acquired by purchase of the small holdings of the investing public. Thus, in July 1933, The Equity Corporation purchased approximately 39% of the voting power of the United Founders Corporation, an investment trust controlling several other investment companies, directly from its sponsors, Louis H. Seagrave, Christopher F. Coombs and Frank B. Erwin.[104] Similarly, The Equity Corporation purchased control of Reliance International Corporation[105] and American, British and Continental Corporation from Atlas Corporation, an investment company which was the largest single holder of the securities of the two trusts.

In purchasing control of a company from its existing management, The Equity Corporation frequently would pay substantial premiums to obtain a position of dominance. For example, to acquire 39% of the voting stock of United Founders Corporation, possessing an aggregate asset value of approximately $1,000,000,[106] The Equity Corporation paid the sponsors of United Founders Corporation $954,000 in cash and 260,150 shares of its common stock, having a market

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ferred stock of Reliance International Corporation had the right to elect a majority of the board of directors. The Equity Corporation owned directly 31.6% of this stock. The Equity Corporation owned directly 45.6% of the company's outstanding common stock. This, together with its holdings of preferred stock, gave The Equity Corporation 42.6% of the general voting power. In addition, it held indirectly 7.7% of the common stock. This represented an additional 6% of the voting power in the company. Thus The Equity Corporation's control of the general voting power, measured by the total of its direct and indirect holdings of preferred and common stock, represented 48.6% of the total. Similarly, at the same time, The Equity Corporation held indirectly 50.1% of the voting power of Chain & General Equities, Inc. (id., Commission's Exhibit No. 843, and the reply to the Commission's questionnaire for Chain & General Equities, Inc., Pt. I, Exhibits A, B); 51.8% of the voting power of Interstate Equities Corporation (op. cit. supra, note 3, Commission's Exhibits Nos. 2 and 843); 37% of the voting power of United Founders Corporation (id., Commission's Exhibit No. 843, and the reply to the Commission's questionnaire for United Founders Corporation, Pt. I, Exhibits A, B); 77.1% of the voting power of American Founders Corporation (op. cit. supra, note 3, Commission's Exhibit No. 843, and the reply to the Commission's questionnaire for American Founders Corporation, Pt. I, Exhibits A, B); and 55.9% of the voting power of America and Continental Corporation (op. cit. supra, note 3, Commission's Exhibit No. 843, and the reply to the Commission's questionnaire for American and Continental Corporation, Pt. I, Exhibits A, B).

[104] This transaction will be discussed in detail later in this chapter. (See infra, pp. 1138–42.)

[105] See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), Part VII, pp. 224–8.

[106] The Equity Corporation acquired two-thirds of the Class A stock of United Founders Corporation, which had an asset value of $30,000 (op. cit. supra, note 3, at 8584–8, and Commission's Exhibit No. 797), and 635,000 shares of the common stock of United Founders Corporation, which had an asset value of $1.59 per share (id., Commission's Exhibit No. 797).

value of $520,300.[107] The asset losses suffered in the purchase of control were to be retrieved out of the gains made by The Equity Corporation on its purchases or exchange offers for the securities of the acquired company held by the public.

Also characteristic of The Equity Corporation's campaign of acquisition was the frequent use of the funds of the subsidiaries to finance its acquisitions of control. In July 1933, control of United Founders Corporation was acquired by a syndicate composed of, and financed by, subsidiaries of The Equity Corporation.[108] Again, in September 1933, The Equity Corporation formed a syndicate known as General American Life Insurance Corporation to take over the assets of the Missouri State Life Insurance Company.[109] As has been indicated, Interstate Equities Corporation, controlled by The Equity Corporation, advanced $1,500,000 out of total participations aggregating $1,750,000.[110] On other occasions The Equity Corporation would finance its acquisitions through bank loans.[111] These loans, however, would ultimately be repaid out of assets of subsidiaries

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[107] Id., at 8637. The common stock of The Equity Corporation had a market value of approximately $2 per share (id., at 8637–8), so that the total market value of the block of this common stock transferred to the sponsors of United Founders Corporation was $520,300.

[108] Id., Commission's Exhibit No. 804, and the reply to the Commission's questionnaire for The Equity Corporation, Pt. I, Exhibit J3.

[109] Op. cit supra, note 3, Commission's Exhibit No. 721.

[110] Ibid.

[111] The Equity Corporation, during the period from December 1933 to March 1935, made extensive bank loans, aggregating approximately $3,300,000 (op. cit. supra, note 3, at 8463–4, 8498). The proceeds of $2,280,000 of these loans were used to finance the initial purchase of the stock of Reliance International Corporation (id., Commission's Exhibit No. 780. The Equity Corporation pledged portfolio securities which at their asset value were worth $8,673,449.13. On the same basis of evaluation, The Equity Corporation's total holdings of securities were worth $8,827,822.61). When examined with respect to these loans, Mr. Milton testified (id., at 8463–4, 8498):

Q. * * * The first transaction in connection with your acquisition of control of Reliance International was the purchase from Atlas Corporation and National Securities Investment Company, on December 7, 1934, of Class A stock for cash, 275,194 shares of Class A Reliance International Corporation, and 37,288 shares of the preferred, and for that you paid $1,912,922 in cash to the Atlas; isn't that so?
A. That is right.
Q. Where did you get the money?
A. We borrowed it.
Q. How much did you borrow?
A. That was $2,280,000 at the end of the year.

* * * * * * *

Q. Now, in March, or from December 1934, when you had that loan of $2,280,000, to March 25, 1935, that loan was increased to $3,300,000; isn't that so?
A. That is approximately right. I will make a correction if it isn't right?
Q. And an additional $1,000,000 was used for what purpose; do you recall? Was that used to purchase additional Interstate stock?
A. Reliance, I believe, to a great extent. I think some Interstate, maybe.

* * * * * * *

Q. And you had to put up some collateral to secure that loan, didn't you?
A. Yes, indeed.
Q. That is, The Equity Corporation did?
A. That is right.

* * * * * * *

Q. Now, virtually, The Equity Corporation hypothecated every security in its portfolio?
A. Substantially.

* * * * * * *

Q. * * * So that you hypothecated the entire Equity Corporation and its interests in all of its subsidiaries to raise approximately two and a quarter million dollars, so that you could buy this investment trust from the Atlas [Corporation] interests; isn't that so?
A. Yes; substantially so; but I wish to point out that the loan was amply covered by this collateral, and it would have made very little difference whether we collater-

absorbed by The Equity Corporation through merger.[112] Thus, The Equity Corporation's expansion program would be fed continually by the assets of the companies acquired.

After consummating the initial step of acquiring voting or working control, The Equity Corporation would consolidate its position by means of exchanges of its securities for securities held by stockholders of its subsidiaries until sufficient additional stock had been acquired to enable The Equity Corporation to absorb the assets of those companies by dissolution, merger, or consolidation.[113]

The Equity Corporation, the dominant company in its system of investment companies, set the terms, favorable to itself, on which the exchange programs were to be carried out. Various devices were

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alized the loan in a smaller amount, because The Equity Corporation, of course, would have been liable to the full extent of the loan in any event.

Q. You didn't give the bank anything that they weren't asking for, Mr. Milton, did you?

A. We told them that we would give them anything that they would like to have.

Q. And they asked for the whole Equity Corporation, subsidiaries and all, and United Founders Corporation; isn't that so?

A. I don't remember whether they asked for it, but we put it up and they got it.

[112] On March 25, 1935, The Equity Corporation caused to be merged into it two of its controlled companies, Chain & General Equities, Inc., and Interstate Equities Corporation. Part of the assets "flowing" into The Equity Corporation as a result of the merger was used to reduce the outstanding loan. Mr. Milton testified (id., at 8499–8500):

Q. Now, you had this $3,300,000 in loans by The Equity Corporation, that is the top holding company, and then on March 25, 1935, when you merged the Chain & General Equities, Inc., and Interstate Equities Corporation into The Equity Corporation, you came into some cash, did you not?

A. The merged company naturally was in a liquid position. Generally, as a result of a merger, there was cash; that is right.

Q. And then you used $2,000,000 of that cash to pay off part of the $3,300,000 on the loan, isn't that so?

A. Out of the liquid position, the loan was paid off, is that right? The liquid position of the merged corporation was used to pay off the loan.

Q. That is $2,000,000 of it.

A. That is right.

The $1,300,000 balance of the loan, together with an additional $700,000 borrowed to enable The Equity Corporation to increase its interest in Reliance International Corporation, was paid off in the same manner. On September 6, 1936, Reliance International Corporation and American, British & Continental Corporation were merged into The Equity Corporation. Part of the assets acquired by The Equity Corporation on the merger were used in final settlement of the loan. Mr. Milton testified (id., at 8501–2):

Q. Now, you still had $1,300,000 that you owed the banks, isn't that so?

A. That is right.

Q. And then from March 25, 1935, to September 6, 1935, those loans increased from $1,300,000 to $2,000,000, isn't that so?

A. Is that figure taken as of the time prior to the merger, and I don't have that figure, and if you want to introduce it subject to correction, I am perfectly willing that you do so.

Q. Now, what did you use that additional $700,000 for during that period from March 25 to September 6, 1935?

A. Mostly for the purchase of Reliance, I believe.

Q. And then you remember on September 6 there was another merger between Reliance International and American, British & Continental Corporation?

A. Two streams flowing together.

Q. But these were golden streams with the money flowing into Equity, isn't that so?

A. They were money and securities.

Q. That is right; and after the two streams met and flowed into Equity, then you took——

A. Flowed into the continuing company.

Q. And then you had $2,000,000 with which you paid off all of the loans, isn't that so?

A. I think so.

Q. And there is another instance where you borrowed $700,000 and used it to buy Reliance International Corporation stock, and then had it flow into the continuing company, and got the cash, and paid off——

A. As a result of the merger.

Q. And paid off the loan which you used to help you acquire control of Reliance International, isn't that so?

A. Yes; and the resulting merged company paid off the loan.

[113] For detailed discussion of these methods used by The Equity Corporation, see the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, p. 229, et seq.

employed to induce stockholders to accept the exchange offers. The Equity Corporation made extensive use of its numerous business contacts with banks, brokerage firms, trust companies and other concerns to bring pressure upon individual stockholders to accept the exchanges.[114]

The services of a nation-wide dealer organization were employed. Equally significant in the success of the program was the careful use made of the solicitation literature. The employment of inadequate financial statements and the failure to make full disclosure of significant aspects of The Equity Corporation characterized the solicitation campaign. Inertia and lack of enthusiasm on the part of stockholders were met with "awakening" and "pressure" devices designed to speed up consummation of the exchange programs.[115]

Almost 50 exchange offers were made to the stockholders of 14 companies in the period from March 15, 1933, to May 20, 1935; [116] in all but two instances The Equity Corporation induced the exchange of stock sufficient, when added to its existing holdings, to enable The Equity Corporation to effect, alone, a dissolution, merger or consolidation of the acquired company under the appropriate state laws.[117]

The final step in The Equity Corporation's expansion program consisted of the absorption of the assets of its subsidiaries directly into itself by means of dissolutions and mergers, or indirectly into a controlled company through a consolidation.[118] By the device of merger or consolidation, numerous stockholders who had refused voluntarily to accept The Equity Corporation's exchange offers were made stockholders of The Equity Corporation by operation of law, unless these stockholders exercised their statutory right of appraisal. Large amounts of assets that would have gone to these investors upon dissolution of their companies were, instead, brought under The Equity Corporation's control.[119] In most cases, these shifts were accomplished at the dictation of the common stockholders, who possessed the necessary voting power but who had little or no equity in the companies to be merged or consolidated. The largest common stockholder in all these instances was The Equity Corporation.[120]

These reorganizations represented the will of dominant persons in The Equity Corporation. Through control of the directorates of its subsidiary companies, the management of The Equity Corporation could determine if and when the corporate existence of these subsidiaries should be terminated. In the same way, the terms of the merger or consolidation agreements were fixed by The Equity Corporation. Similarly, stockholder approval of the dissolutions,

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[114] Ibid; see also infra, pp. 1368 and 1371.

[115] Ibid.

[116] Op. cit. supra, note 3. Commission's Exhibits Nos. 839 and 840.

[117] Op. cit. supra, note 113, p. 293.

[118] Id., pp. 294–336.

[119] Id., pp. 309–11.

[120] The percentage of the total outstanding votes represented by the holdings of Mr. Milton and Mr. Huntington declined steadily until by September 20, 1935, they controlled only about 20% of the voting power of The Equity Corporation (op. cit. supra, note 3, Commission's Exhibits Nos. 773, 832 (pp. 12–13) and Securities Registration Statement, The Equity Corporation, post-effective amendment filed July 14, 1937, Item 26). This holding apparently represented effective working control, however, for no other single interest held a block of comparable size. (Reports filed with this Commission by the corporation and stockholders indicate that no one except the dominant management group owned beneficially 10% or more of any class of equity securities at the time stated.)

mergers and consolidations was merely a formality. In almost all cases The Equity Corporation itself controlled sufficient percentages of the votes to effect the type of reorganization determined upon, irrespective of the wishes of the public investors.[121] In one instance where The Equity Corporation did not possess sufficient votes under the applicable state law, it caused its subsidiaries to amend their charters so as to circumvent the statutory obstructions to the imposition of The Equity Corporation's plan upon public holders of the senior securities and common stock of these companies.[122]

2. ASSET LOSSES SUFFERED BY STOCKHOLDERS OF ACQUIRED COMPANIES

The methods of reorganization engaged in by The Equity Corporation worked drastic changes in the rights and privileges of security holders. Thus, preferred stockholders who accepted exchange offers and agreements of merger or consolidation proposed by The Equity Corporation surrendered securities possessing preferences on liquidation of approximately $8,400,000, more than the preferences of the securities received.[123] Similarly, those preferred stockholders whose securities were acquired by The Equity Corporation by exchange offer, merger, or consolidation, suffered a loss in net asset values of approximately $2,000,000.[124]

These alterations of the rights, privileges, and asset values of minority stockholders may have been accompanied by some advantages to these stockholders. Minority stockholders may have been benefited by the simplification of corporate structures incident to the reorganizations effected by The Equity Corporation, and the stock of The Equity Corporation which they obtained may have possessed a marketability superior to that of their former holdings. However, these alterations of the rights, privileges, and asset values of the securities of minority stockholders effected by The Equity Corporation are indicative of the powers which dominant groups can assume over the investments of other people without control or regulation of any kind.

C. Atlas Corporation

Atlas Corporation represents the outgrowth of a small company known as United States Company formed in 1923 by Floyd B.

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[121] Op. cit. supra, note 113, pp. 294–315.

[122] See infra, pp. 1485–99, for a discussion of the consolidation of the companies in the "Founders group" into American General Corporation.

[123] Op. cit. supra, note 3, Commission's Exhibit No. 775. The value in liquidation of shares exchanged and shares surrendered was $20,109,034. The value in liquidation of the preferred stock of The Equity Corporation issued in exchange for these shares was $11,763,486.50 (ibid.).

[124] Id., Commission's Exhibits Nos. 767, 768, 770, 772, 773, 774, 775, 840, 845, 846, 847, 848, and the reply to the Commission's questionnaire for The Equity Corporation, Pt. I, Exhibit J9. The approximate net asset value of shares exchanged and shares surrendered on merger was $14,066,913. The approximate net asset value of shares of The Equity Corporation issued in exchange for these shares was $11,858,575 (ibid.).

Odlum [125] (who was to become the "dominating influence" [126] in Atlas Corporation), George H. Howard and the wives of these two men. The company was formed primarily as a hobby, "to set aside a certain amount of funds to see what could be done." [127] The initial capital of the United States Company consisted of $40,000 contributed in equal sums of $10,000 by each of the four incorporators.[128] Each of the incorporators received 2,500 shares of the common stock of the company.[129] In 1924, L. Boyd Hatch, Mr. Odlum's brother-in-law, became associated with United States Company. Later, other friends of the incorporators were permitted to become subscribers to the stock of United States Company.

In August of 1928, United States Company had net assets of approximately $600,000,[130] of which $300,000 represented contributed capital [131] and $300,000 represented appreciation in the value of the company's investment portfolio.

On August 3, 1928, Mr. Odlum and his associates caused to be incorporated, under the laws of Canada, an investment company, Atlas Utilities Investors Company, Ltd.,[132] with an authorized capitalization of 10,000 shares of $100 par value preferred stock and 200,000 shares of no par value common stock.[133] By an exchange offer [134] of its shares the Canadian company acquired, in August of 1928, all of the outstanding securities of United States Company and thus became possessed of approximately $600,000 in net assets. Additional capital of approximately $3,000,000 [135] was raised by the Canadian company by private sales of its securities to friends of its founders and by the exercise of option warrants. Mr. Odlum and Mr. Howard, their wives, and Mr. Hatch held a total of 41,000 shares of the Canadian company's common stock which had been acquired by them under the terms of the Canadian company's exchange offer for the securities of United States Company and option warrants to purchase at any time 47,000 shares of the common stock of Atlas Utilities Investors Company, Ltd.[136] On July 11, 1929, another

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[125] Derived from supplementary information supplied the Commission for Atlas Corporation. In 1923 Floyd B. Odlum was a vice president of the Electric Bond and Share Company and of American & Foreign Power Company, an affiliated company (Public Examination, Atlas Corporation, at 17521). From 1926 to 1931, Mr. Odlum spent most of his time abroad acquiring public utility properties for American & Foreign Power Company. In 1931 Mr. Odlum severed his relationships with Electric Bond and Share Company and American & Foreign Power Company to devote his full time to his duties as the president and a director of Atlas Corporation (ibid.).

In 1923, George H. Howard was associated as an attorney with the New York law firm of Simpson, Thatcher and Bartlett, who were counsel for Electric Bond and Share Company and American & Foreign Power Company. From 1929 to 1935, Mr. Howard was a director of Atlas Corporation (id., Commission's Exhibit No. 2002) and from 1929 to April 1940 has been the president and a director of The United Corporation.

[126] Public Examination, Atlas Corporation, at 17519–22.

[127] Id., at 17523.

[128] Id., at 17524.

[129] Ibid.

[130] Id., Commission's Exhibit No. 1933.

[131] Id., Commission's Exhibit No. 1932.

[132] Id., Commission's Exhibit No. 1931.

[133] Id., Commission's Exhibit No. 1932.

[134] Ibid.

[135] Id., Commission's Exhibit No. 1934.

[136] Id., at 17533. The securities and option warrants issued were divided as follows: 10,000 shares of common stock and 10,000 option warrants to Floyd B. Odlum; 10,000 shares

investment company, Atlas Corporation, was incorporated in Delaware [137] with an authorized capitalization of 100,000 shares of preferred stock (none of which was ever issued), 200,000 shares of preference stock having one vote per share and entitled on liquidation to a preference in assets to the extent of $50 per share and accrued unpaid dividends, and 1,200,000 shares of common stock, all of no par value.[138] On July 18, 1929, a so-called copartnership comprised of Floyd B. Odlum, Mrs. Odlum, George H. Howard, Mrs. Howard, and L. Boyd Hatch, transferred securities having a value of $3,035,000 [139] to Atlas Corporation in consideration of the issuance to the copartnership by the corporation of 300,000 shares of its common stock and perpetual option warrants to purchase 50,000 shares of the corporation's common stock at $25 per share.[140] Included in the securities so delivered to Atlas Corporation by the copartnership were the 41,000 shares of the common stock of the Canadian company which the copartners had received in exchange for their United States Company stock.[141] Three of the copartners, Messrs. Odlum, Hatch, and Howard, became directors of Atlas Corporation.[142] The other two directors on the board of five were E. K. Hall and Reeve Schley, both of whom were stockholders of the Canadian company.[143]

The copartnership further agreed to use its best efforts to obtain purchasers for 150,000 units of Atlas Corporation's securities at a price of $58 per unit, each unit to consist of one share of preference stock entitled to one vote per share for all corporate purposes and to a preference of $50 per share on liquidation of the corporation, one share of common stock and one perpetual option warrant to purchase one share of the corporation's common stock at a price of $25 per share.[144] Pursuant to this agreement, the copartnership, prior to the close of 1929, succeeded in selling 154,721 of these units of the corporation's securities at $58 per unit, netting the corporation $8,973,818.[145] The units were sold privately by the copartnership and no commission was retained by the copartnership. In addition to the $58 units, the corporation also sold privately at $10 per unit, units consisting of one share of its common stock and a perpetual option warrant to purchase 1/6th of a share of its common stock at a price of $25 per share.[146] Of these units 54,100 were sold prior to December 31, 1929, netting the corporation $541,000. Thus, the total cash derived by

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of common stock and 10,000 option warrants to Mrs. F. B. Odlum; 10,000 shares of common stock and 10,000 option warrants to George H. Howard; 10,000 shares of common stock and 10,000 option warrants to Mrs. G. H. Howard; 1,000 shares of common stock and 7,000 option warrants to L. Boyd Hatch.

[137] Id., Commission's Exhibit No. 1942.

[138] Ibid.

[139] Id., Commission's Exhibit No. 1957.

[140] Id., Commission's Exhibit No. 1935. The 300,000 shares of common stock and the 50,000 warrants were divided as follows among the members of the copartnership: L. Boyd Hatch, 15,690 shares of common and 2,615 warrants; George H. Howard, 80,655 shares of common and 13,442½ warrants; Elizabeth S. Howard, 61,500 shares of common and 10,250 warrants; Hortense B. Odlum, 61,500 shares of common and 10,250 warrants; Floyd B. Odlum, 80,655 shares of common and 13,442½ warrants (id., Commission's Exhibit No. 2002, (p. 30).)

[141] See supra, p. 1053.

[142] Op. cit. supra, note 126, Commission's Exhibit No. 1943.

[143] Ibid.

[144] Id., Commission's Exhibit No. 1935.

[145] Id., Commission's Exhibit No. 1960.

[146] Ibid.

Atlas Corporation in 1929 from the sale of its $58 and $10 units was $9,514,818.

On October 1, 1929, an exchange offer by Atlas Corporation of its securities for the common stock of the Canadian company was made.[147] As a result primarily of this exchange offer, Atlas Corporation acquired all of the outstanding common stock of the Canadian company,[148] which, however, was not immediately dissolved but was continued as a subsidiary of Atlas Corporation until October 1936,[149] when it was dissolved as a step in the final simplification of the Atlas Corporation system of investment companies.

By the close of 1929, Atlas Corporation had acquired by sale or exchange of its securities, by its transaction with the copartnership, and by its absorption of the Canadian company, assets having an actual value of approximately $17,000,000.[150] Of this amount of assets, approximately $12,000,000 represented contributed capital and paid-in surplus.[151] Investments of the company were primarily concentrated in the common stocks of utility operating and holding companies, particularly those of the Electric Bond and Share Company and its subsidiaries.[152] The effect of the stock market collapse of 1929 was to reduce the assets of the corporation to $13,460,000, a decline of 21% of its actual contributed capital.[153] The so-called "spring rally" of 1930 restored Atlas Corporation to its approximate original asset position, but by this time Mr. Odlum had lost faith in the possibility of an immediate substantial rise in the market price of securities.[154] At this time the policy of the corporation to devote itself to the absorption of other investment trusts and investment companies was formulated.[155]

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[147] Id., Commission's Exhibit No. 1936.

[148] The asset value of the Canadian company's common stock was approximately $55 per share (derived from supplementary information supplied the Commission for Atlas Corporation), whereas the asset value of Atlas Corporation common stock was approximately $10.37 per share (ibid.). The four shares of Atlas Corporation common stock issued in consideration for one share of the common stock of the Canadian company had, therefore, an asset value of $41.48. The Canadian company's common stockholders in making this exchange thus suffered a loss in assets of approximately $14 per share which was compensated somewhat by the receipt of option warrants of Atlas Corporation and by the fact that Atlas Corporation's common stock had a substantially higher "leverage" than did the Canadian company's stock.

[149] Op. cit. supra, note 126, at 17553.

[150] Id., at 17771.

[151] Id., at 17702.

[152] Id., at 17771.

[153] Ibid.

[154] Id., at 17719.

[155] Mr. Odlum testified (id., at 17719–21):

> A. * * * When we got to April 1930 we had again pulled it up so that from the organization of the company to April 1930 we had suffered no losses. But we were in a period of falling prices. We didn't know how long that period was going to last or or how far it was going to go. We sensed that perhaps it might last for a considerable period of time. We were just organized about six months. We could turn our capital back to our shareholders without loss, or we could carry on. If we turned to carry on as a straight investment company, so to speak, we would be a victim of the general market conditions if they continued downward. Therefore we searched for some way so that we could do better at least than market averages if the market should fall further and so that we would do better than market averages if the market continued as it was, and we would be rather fully invested if the market should turn upward overnight.
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> * * * * * * *
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> If we could get in and get control of those companies at a figure which was something above this 35 or 40% discount, but at some discount so that in effect we would share with those old shareholders a part of the spread between the asset values and the market values of their securities, we would in effect have that protection, let it be 10

During 1930, Mr. Odlum's investigation of investment companies had led to the discovery that the market value of investment company securities was at least 35% less than the actual value of the assets owned by the holders of such securities.[156] The opportunity thus presented to acquire the portfolios of diversified securities of other investment companies at a total price less than their actual value was the fundamental purpose of the Atlas Corporation's campaign to acquire control of, and to amalgamate with itself, the assets of other investment companies.[157] Subsidiary advantages also accrued to Atlas Corporation and its sponsors. To the extent of the differential between the cost of the securities of investment companies acquired by Atlas Corporation and its actual value, Atlas Corporation was provided with a "cushion" against further depreciation in the market value of securities. And through the medium of its exchange offers Atlas Corporation was enabled to distribute its own securities for the securities of other companies having asset values in excess of the asset and market value of its own securities.[158] In substance, a means was thereby found to raise additional capital in a period when the sale of Atlas Corporation's own securities by normal methods was virtually impossible.[159]

On October 31, 1931, Mr. Odlum entered into a contract [160] to manage the expansion program of Atlas Corporation. By the terms of this contract Mr. Odlum agreed to devote his full time to the active management of Atlas Corporation for a period of one year.[161] As compensation Mr. Odlum was to receive a sum equal to 6/10 of 1% of the consolidated net assets of the corporation as at the date of the termina-

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or 15 per cent of that discount, if you please, against a further fall in the market. We would be fully invested if the market should rise, and we would have that spread also, if the market just remained constant. And we would at the same time be giving those other people several things that they didn't have. In the first place we would be giving them marketability that they didn't have. In the second place we would be giving them management which they didn't have, at least I don't mean that as a criticism of the old management. The managements had gone dead and weren't doing anything about it all. And we were in the field; we were interested; we were trying to make good on the thing and we were active. Therefore, we added to what they had: (1) market value; (2) portfolio management; and (3) an opportunity to at least take a chance of going forward, rather than sit and watch a thing coming down on them.

That is the genesis of the adoption of the program or the policy of acquiring investment trusts. But I say it was a phase because the minute we had acquired these trusts, the minute the market had gone through the depression period and we had accumulated those trusts, we were back again without any subsidiaries, without anything except our own portfolio, to manage which would be a consolidation of our original portfolio plus what we acquired, and we would have as our shareholders our original shareholders plus these other fellows we had brought in——

[156] Op. cit. supra, note 126, at 17719–21.

[157] Ibid.

[158] See infra, pp. 1070; 1400–8.

[159] Mr. Odlum testified (op. cit. supra, note 126, at 17724):

Q. I think you will agree that in this demoralized period you couldn't sell investment trust securities?

A. Yes; but at a very great sacrifice.

Q. So that if it was a question of raising additional capital to start this campaign by selling new Atlas stock, that would be futile; isn't that so? You couldn't float or sell a big block of Atlas stock on a public offering at that time.

A. No. * * *

Mr. Odlum further testified in this connection (id., at 17834):

A. * * * Many people interpreted our program in the investment trust field as an effort on our part to gather together capital. We had no idea nor any desire to gather capital.

Q. But you don't deny that was the consequence of your program?

A. The consequence of our program was to build our capital up from about $17,000,000 to somewhere around $100,000,000, and in fact * * * it built up at one period to $140,000,000, and we have been constantly cutting it down ever since, because it wasn't capital we wanted.

[160] Id., Commission's Exhibit No. 1964.

[161] Ibid.

tion of the contract less a sum equal to all operating expenses.[162] In other words, if the operating expenses of the corporation exceeded 6/10 of 1% of the consolidated net assets of the corporation, Mr. Odlum would receive no compensation. Mr. Odlum also agreed to subscribe for 200,000 shares of the corporation's common stock and 200,000 of its warrants at a price of $6.50 for a unit consisting of one share of common stock and one warrant,[163] or a total price for the 200,000 units of $1,300,000.[164] The then market value of each of these units was $6; the asset value of each of the units was then $3.95. Mr. Odlum, however, had the right under the terms of the contract to cancel his subscription, if as at November 31, 1934, the Dow-Jones 30 common stock industrial average or an equivalent index was more than 35% below the level of such average as at July 31, 1931.[165]

Up to October 1931 (the time of the maturing of the management agreement between Mr. Odlum and Atlas Corporation), Mr. Odlum had received no compensation in any form from Atlas Corporation or any of its predecessor companies. During this period up to 1931, the Atlas Corporation had acquired control of the following investment companies: All America General Corporation, with assets of $3,149,700; Exide Securities Corporation, with assets of $5,837,900; Power & Light Securities Trust, with assets of $3,014,300; Selected Stocks, Inc., with assets of $596,100; Iroquois Share Corporation, with assets of $1,441,400; Federated Capital Corporation, with assets of $2,845,000; Jackson & Curtis Investment Associates, with assets of $1,039,600; Sterling Securities Corporation, with assets of $16,764,800; Chatham Phenix Allied Corporation, with assets of $29,412,700; Chain Store Stocks, Inc., with assets of $3,407,200; and National Securities Investment Company, with assets of $11,243,300.[166] Total assets of all investment companies, control of which was acquired by Atlas Corporation prior to its execution of its management contract with Mr. Odlum, were approximately $78,752,100. However, in several of these companies, sufficient stock control to effect their dissolution or merger with Atlas Corporation had not yet been obtained, and negotiations for the acquisition of control of additional companies by Atlas Corporation were in progress at the date of the corporation's contract with Mr. Odlum.[167] The objective of the contract was to insure his services for

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[162] Ibid. [163] Ibid. [164] Ibid. [165] Ibid.

[166] Id., Commission's Exhibit No. 1958.

[167] As at December 31, 1931, Atlas Corporation and its subsidiaries had the following interest in the companies then controlled by the Atlas Corporation group of companies:

Name of company:	*Percent of securities of each class owned by Atlas Corporation*
Securities Allied Corporation	40. 48
Allied Atlas Corporation	92. 47
All American General Corporation	68. 42
Chain Store Stocks, Inc	66. 06
Ungerleider Financial Corporation	82. 02
General Empire Corporation	74. 05
National Securities Investment Company:	
Preferred	26. 59
Common	66. 34
Sterling Securities Corporation:	
1st preferred	15. 57
$1.20 preferred	6. 46
Class A	14. 38
Class B	70. 63
Aviation Securities Corporation	50. 42
Federated Capital Corporation:	
Preferred	32. 65
Common	13. 29

Securities Allied Corporation, in which the Atlas Corporation group had only a 40.48% interest, controlled, either itself or through controlled companies, all of the Atlas Cor-

the furtherance and consummation of the corporation's acquisition program. Mr. Odlum testified that he had no belief that the market would rise substantially during the period of the corporation's expansion program.[168] Consequently the purpose of the management contract was apparently to compensate Mr. Odlum for any increase in the consolidated assets of the corporation which would result from his efforts to acquire control of other investment companies.[169] It is evident also that, as a result of his management contract and his stock purchase agreement, Mr. Odlum had a direct pecuniary interest in the exchange offers of securities made by Atlas Corporation for the securities of its subsidiaries from the point of view of both increase in total assets and maximum profit to Atlas Corporation.

On October 31, 1932, the date of the expiration of the original management contract with Mr. Odlum, the contract was by agreement modified and extended to April 30, 1933,[170] because "events of the past year have prevented the consummation within the year of the expansion and consolidation program which was in our minds when the agreement of October 31, 1931, was made."[171] Mr. Odlum agreed to make his purchase of the 200,000 units of Atlas Corporation securities unconditional, and further agreed that this management compensation under the contract for its entire term, past and future, was not to exceed $300,000, with the proviso, however, that in any event he was to receive for his services a minimum of $150,000. Mr. Odlum, on the termination of his management contract, received $300,000, the full compensation to which he was entitled by its terms.[172] The gains made by Mr. Odlum on his purchase of the 200,000 units of Atlas Corporation securities will be indicated later.

Prior to May 1930, the portfolio of Atlas Corporation consisted predominantly of utility securities.[173] As at May 31, 1930, the corporation's portfolio at cost totaled $11,231,846.77, of which $6,248,380, or 57.7% of the total portfolio, was invested in the securities of public utility companies.[174] In May 1930, the corporation commenced its program to acquire other investment companies and thereafter reduced gradually its portfolio of marketable securities to provide funds for this program. At December 31, 1930, the company's portfolio of securities at cost totaled $7,203,651.89, of which $3,910,026.45, or 54.28% of the total, was represented by public utility securities.[175] However, by April 1931 the corporation had transformed its entire portfolio, at a realized loss of approximately $6,000,000,[176] to investments only in the securities of other investment companies.

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poration group holdings in Allied Atlas Corporation, All American General Corporation, Chain Store Stocks, Inc., Ungerleider Financial Corporation, National Securities Investment Company, and Aviation Securities Corporation. The $1.20 preference, the Class A and Class B common stocks of Sterling Securities Corporation had no asset value as at December 31, 1931. Atlas Corporation's main interest was, therefore, in the preferred stock which it was mainly engaged in acquiring (id., Commission's Exhibit No. 2001).

[168] See note 155, supra.

[169] Op. cit. supra, note 126, at 17733–5.

[170] Id., at 17736 and Commission's Exhibit No. 1964.

[171] Id., Commission's Exhibit No. 1964.

[172] Id., at 17738.

[173] Id., Commission's Exhibit No. 2002, p. 48.

[174] Ibid.

[175] Ibid.

[176] Id., Commission's Exhibit No. 2002, p. 49. Of this $6,000,000, $3,700,000 were net losses on intercompany transactions (ibid.).

1. CHANGE IN INVESTMENT POLICIES OF COMPANIES ACQUIRED BY ATLAS CORPORATION

Further funds were provided for a continuance of the Atlas Corporation's program of acquisition by the companies acquired by Atlas Corporation. With few exceptions, as control of each of the 22 companies ultimately absorbed by Atlas Corporation was acquired, their diversified portfolios were liquidated and the funds so derived were used to acquire from Atlas Corporation itself and its existing subsidiaries or in the open market the securities of other investment companies control of which Atlas Corporation was then in the process of acquiring. Mr. Odlum testified to this process as follows:[177]

Q. Well, as I read these reports it seems to me that the technique was, first, to find the situation where you could buy the securities at these discounts, isn't that so?

A. Buy for cash.

Q. And in these substantial companies where you didn't have the requisite cash to buy the entire control of the situation you bought a substantial position in the trust and then made the exchange offer, isn't that so?

A. In every case we bought all that we could for cash. I don't mean limited by our cash resources, I mean that we bought every share that we could for cash and preferred to buy for cash than to issue stock for it.

Q. But a substantial part was acquired by the issuance of stock.

A. The majority was acquired through purchase for cash.

Q. And the cash came not only from Atlas, but came from the subsidiaries.

A. As we acquired some of these subsidiaries they became partners with us and their capital was used.

Q. But when you say that you bought for cash, you don't mean that the Atlas Corporation used its own cash, but it used the cash of the companies which it had acquired control of either by purchasing their securities for cash or upon the exchange program.

A. But it wasn't because we had acquired control of them, it was because they were under our management and joined the same program that we were in for the same objectives.

Q. I am not unmindful of that, but I am trying to see what the technique was, and where the money came from and how these various companies were acquired. In many instances, Atlas Corporation used its own cash and in many other instances it used the cash of companies which it controlled, no, in almost——

A. No; that is an incorrect statement, that "it used"—but "they" used.

Q. They used?

A. Yes * * *.

The extent to which the diversified portfolios of marketable securities held by the companies acquired by Atlas Corporation prior to the shift in their control to Atlas Corporation were replaced by the securities of investment companies which were eventually absorbed by Atlas Corporation is indicated by Table 15.[178]

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[177] Id., at 17727–9.

[178] Id., Commission's Exhibit No. 2039.

TABLE 15.—*Investments in affiliates by investment companies in the Atlas Corporation group, 1930–35 year-ends*

Investment company	Date of acquisition of control	1930			1931		
		Total portfolio	Investments in affiliates		Total portfolio	Investments in affiliates	
			Amount	Percent of portfolio		Amount	Percent of portfolio
Atlas Utilities & Investors Co., Ltd	July 18, 1929	$3,695,817	$204,175	0.5	$3,114,096	$2,860,865	91.9
All American General Corp	June 30, 1930	1,287,624			1,469,027	1,440,000	98.3
Exide Securities Corp. (later Allied Atlas Corp.)	Aug. 31, 1930	2,941,170	103,075	0.4	3,145,312	2,705,036	86.0
Power & Light Securities Trust	Feb. 28, 1931			([b])	[a] 2,038,184		
Selected Stocks, Inc	Mar. 31, 1931			([c])	[a] 218,637	[a] 199,975	91.5
Ungerleider Financial Corp. (later The Financial Corp.)	Apr. 30, 1931				1,540,411	165,000	10.7
Iroquois Share Corp	do			([d])	[a] 831,079		
Federated Capital Corp	May 16, 1931				1,315,362		
General Empire Corp	June 1, 1931				2,933,061	884,472	30.2
Jackson & Curtis Investment Assoc	July 31, 1931			([e])	[a] 1,067,128		
Sterling Securities Corp	do				7,516,241	102,623	1.4
Chatham Phenix Allied Corp (later Sec. Allied Corp.)	Aug. 5, 1931				14,664,890	7,725,902	52.7
Chain Store Stocks, Inc	Sept. 16, 1931				1,265,554	873,250	69.0
National Securities Investment Co	Sept. 25, 1931				4,976,193	1,385,106	27.8
Aviation Securities Corp	Dec. 31, 1931				1,231,100		
Atlantic Securities Corp	Apr. 30, 1932						
Goldman Sachs Trading Corp., The (later Pacific Eastern Corp.)	Apr. 17, 1933						
Blue Ridge Corp	Apr. 25, 1933						
Shenandoah Corp	Apr. 26, 1933						
American Investors, Inc	June 30, 1933						
Atlas Corp		14,282,464	10,853,065	76.0	13,711,587	9,996,319	73.0
Total		22,207,076	11,160,315	50.7	43,171,251	18,142,255	42.2

[a] Market values; other values are book.
[b] Merged June 3, 1931.
[c] Liquidated Aug. 18, 1931.
[d] Liquidated Aug. 28, 1931.
[e] Liquidated Aug. 31, 1931.

TABLE 15.—*Investments in affiliates by investment companies in the Atlas Corporation group, 1930–35 year-ends*—Continued

Investment company	Date of acquisition of control	1932			1933		
		Total portfolio	Investments in affiliates		Total portfolio	Investments in affiliates	
			Amount	Percent of portfolio		Amount	Percent of portfolio
Atlas Utilities & Investors Co., Ltd	July 18, 1929	$2,116,535	$2,106,254	99.5	$3,391,566	$3,253,819	96.0
All American General Corp	June 30, 1930	1,591,527	1,549,527	97.3	[a] [f] 1,608,835	[a] 930,048	57.8
Exide Securities Corp. (later Allied Atlas Corp.)	Aug. 31, 1930	3,120,064	3,046,177	97.6	[a] [g] 3,805,192	[a] 3,701,833	97.3
Power & Light Securities Trust	Feb. 28, 1931						
Selected Stocks, Inc	Mar. 31, 1931						
Ungerleider Financial Corp. (later The Financial Corp.)	Apr. 30, 1931	3,951,794	2,797,610	70.8	[a] [h] 4,364,737	[a] 3,795,919	87.0
Iroquois Share Corp	do						
Federated Capital Corp	May 16, 1931	1,202,272			2,682,231	293,532	10.9
General Empire Corp	June 1, 1931	2,339,311	1,500,188	64.0	[a] [i] 3,690,156	[a] 2,641,279	71.6
Jackson & Curtis Investment Assoc	July 31, 1931						
Sterling Securities Corp	do	6,892,784	175,450	2.5	15,682,578	28,602	0.2
Chatham Phenix Allied Corp. (later Sec. Allied Corp.)	Aug. 5, 1931	16,559,604	13,716,510	82.8	[a] [j] 19,421,848	[a] 14,871,951	76.6
Chain Store Stocks, Inc	Sept. 16, 1931	1,522,412	868,961	57.0	[a] [k] 2,126,043	[a] 1,195,221	56.2
National Securities Investment Co	Sept. 25, 1931	5,461,150	2,752,966	50.4	4,156,268	1,481,812	35.6
Aviation Securities Corp	Dec. 31, 1931	352,687			[a] [l] 1,587,049	[a] 344,120	21.7
Atlantic Securities Corp	Apr. 30, 1932	2,283,441	2,245,384	98.4	[a] [m] 2,039,713	[a] 1,912,914	93.7
Goldman Sachs Trading Corp., The (later Pacific Eastern Corp.)	Apr. 17, 1933				31,537,765	9,508,366	30.2
Blue Ridge Corp	Apr. 25, 1933				41,899,274		
Shenandoah Corp	Apr. 26, 1933				13,741,805	6,232,666	45.4
American Investors, Inc	June 30, 1933				7,934,338		
Atlas Corp		25,580,604	20,867,257	81.6	47,446,660	42,859,489	90.3
Total		72,974,190	51,626,287	70.8	168,472,488	63,658,288	37.8

[a] Market values; other values are book.
[f] Liquidated Dec. 20, 1933.
[g] Liquidated June 6, 1933.
[h] Liquidated Nov. 4, 1933.
[i] Liquidated June 21, 1933.
[j] Liquidated Dec. 8, 1933.
[k] Liquidated Nov. 24, 1933.
[l] Liquidated Nov. 13, 1933.
[m] Liquidated Dec. 30, 1933.

TABLE 15.—*Investments in affiliates by investment companies in the Atlas Corporation group, 1930–35 year-ends*—Continued

Investment company	Date of acquisition of control	1934 Total portfolio	1934 Investments in affiliates: Amount	1934 Investments in affiliates: Percent of portfolio	1935 Total portfolio	1935 Investments in affiliates: Amount	1935 Investments in affiliates: Percent of portfolio
Atlas Utilities & Investors Co., Ltd	July 18, 1929	$10,428,708	$10,306,273	98.8	$14,664,904	$12,316,305	84.1
All American General Corp	June 30, 1930						
Exide Securities Corp., (later Allied Atlas Corp.)	Aug. 31, 1930						
Power & Light Securities Trust	Feb. 28, 1931						
Selected Stocks, Inc	Mar. 31, 1931						
Ungerleider Financial Corp. (later The Financial Corp.)	Apr. 30, 1931						
Iroquois Share Corp	do						
Federated Capital Corp	May 16, 1931	2,638,362	350,717	13.3	[a] [n] 2,774,961		
General Empire Corp	June 1, 1931						
Jackson & Curtis Investment Assoc	July 31, 1931						
Sterling Securities Corp	do	14,676,379	39,327	0.3	18,500,239	67,929	0.4
Chatham Phenix Allied Corp. (later Sec. Allied Corp.)	Aug. 5, 1931						
Chain Store Stocks, Inc	Sept. 16, 1931						
National Securities Investment Co	Sept. 25, 1931	2,961,434	1,675,146	56.6	[a] [o] 6,715,980	[a] 1,708,837	25.4
Aviation Securities Corp	Dec. 31, 1931						
Atlantic Securities Corp	Apr. 30, 1932						
Goldman Sachs Trading Corp., The (later Pacific Eastern Corp.)	Apr. 17, 1933	33,294,216	8,108,847	24.4	41,789,069	13,772,186	33.0
Blue Ridge Corp	Apr. 25, 1933	36,005,643			([p])	([p])	
Shenandoah Corp	Apr. 26, 1933	10,491,433	3,737,528	35.6	26,566,281	1,221,023	4.6
American Investors, Inc	June 30, 1933	6,588,576			[a] [q] 4,868,792		
Atlas Corp		53,687,009	49,812,748	92.8	71,014,359	54,243,607	76.4
Total		170,771,763	74,030,588	43.5	172,534,853	81,621,051	47.3

[a] Market values; other values are book.
[n] Liquidated July 27, 1935.
[o] Liquidated July 25, 1935.
[p] Sold November 1935.
[q] Liquidated July 18, 1935.

Stockholders (other than officers, directors, sponsors, managers, and principal stockholders) of acquired companies were not consulted prior to the substantial change in the investment policies of their companies by Atlas Corporation; they were informed of the change only after it had occurred.[179] The change in policy was a result only of the agreement of Atlas Corporation and the previous managers of the companies acquired by Atlas Corporation,[180] who, as will be described,

[179] Id., at 18235; see also infra, Sec. III.
[180] See infra, Sec. III.

had usually ceded their control to Atlas Corporation on terms advantageous to themselves.[181]

It will be observed from the schedule that to a substantial degree the assets of virtually all of the investment companies acquired prior to 1933 were invested, like the assets of the Atlas Corporation, in the purchase of securities of other investment companies. Companies, the control of which was acquired by Atlas Corporation in 1933, did not make this type of investment for the reason that their acquisition terminated the Atlas Corporation program.[182]

The record indicates that the experience of the stockholders of the companies acquired by Atlas Corporation after they joined with the Atlas Corporation as "partners"[183] in its acquisition program, was comparatively better than would have been the case had the original portfolios of the acquired companies been retained or if their assets had been reinvested in the securities which form the basis for the calculation of the commonly known stock market averages.[184]

The Atlas Corporation and its stockholders benefited by these acquisitions to a far greater extent than minority stockholders of the acquired companies who did not become stockholders of the Atlas Corporation. On the dissolution of their companies by Atlas Corporation, minority stockholders were given the option to take their distributive share of their companies' assets either in cash or in kind in portfolio securities.[185] To a substantial extent these portfolio securities were the securities of other investment companies controlled by Atlas Corporation. The market prices of these securities of other investment companies were substantially under the control of Atlas Corporation,[186] and the asset values of such securities, most of which accrued to Atlas Corporation as liquidating dividends on the dissolution of its subsidiaries, were far in excess of their market values.[187] Ultimately, these asset values were, of course, realized by Atlas Corporation and perhaps by those minority stockholders of the dissolved companies who elected to take their distributive share of their companies' assets in kind.[188] However, the letters offering minority stockholders of dissolving corporations controlled by Atlas Corporation the opportunity to receive the portfolio securities of their companies in kind, did not point out the difference between the asset values and the market values of the Atlas Corporation controlled

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[181] Ibid.

[182] The $9,508,366.50 which the schedule discloses The Goldman Sachs Trading Corporation had invested in an affiliate, was its investment in Shenandoah Corporation, which was made in 1929, prior to the acquisition of control of The Goldman Sachs Trading Corporation by Atlas Corporation. Similarly, the investment of $6,232,666.64 in affiliates by Shenandoah Corporation constituted an investment in Blue Ridge Corporation, which was made in 1929, prior to the acquisition of Shenandoah Corporation by Atlas Corporation.

[183] See note 177, supra.

[184] Op. cit. supra, note 126, Commission's Exhibits Nos. 2004 and 2033. Officials of Atlas Corporation maintain that the acquired companies did better in the aggregate by $19,000,000 than the general market averages and $32,000,000 better than they would have done if they had kept the portfolios they had when they passed under the management of Atlas Corporation. Stated percentage-wise, this management performance was approximately 8% better than the general market and 15% better than it would have been with retention of acquired portfolios.

[185] See infra, pp. 1446–57.

[186] Ibid.

[187] Ibid.

[188] Ibid.

investment company securities in the portfolios of the dissolving companies.[189] The great number of minority stockholders elected to receive their distributive share of the assets of their companies in cash.[190] The cash distributive shares of the assets of the investment companies dissolved by Atlas Corporation were usually calculated on the basis of the market value of the assets of the dissolving companies.[191]

In the course of its program, Atlas Corporation acquired control of 21 investment companies. Of these 21 companies, control of two [192] was sold by Atlas Corporation at a profit, 16 were dissolved,[193] and three were consolidated with Atlas Corporation on October 29, 1936.[194] Table 16 [195] indicates the companies acquired, the names of their sponsors, the total assets of the companies at the date Atlas Corporation acquired control, and their eventual disposition by Atlas Corporation:

TABLE 16.—*Investment trusts and investment companies acquired by Atlas Corporation*

Investment company	Name of sponsor	Date control acquired by Atlas Corporation	Approximate assets at date of acquisition by Atlas Corporation	Disposition
1. Widlor, Inc	Lord & Widli	Mar. 27, 1930	$500,000	Dissolved Mar. 27, 1930.
2. All America General Corporation.	Starring & Co	June 30, 1930	3,149,700	Dissolved Dec. 30, 1933.
3. Exide Securities Corporation (Allied Atlas Corporation).	Electric Storage Battery Co.	Aug. 31, 1930	5,837,900	Dissolved June 6, 1933.
4. Power & Light Securities Trust.	Hale Waters & Co	Feb. 28, 1931	3,014,300	Dissolved June 1, 1931.
5. Selected Stocks, Inc	Quaw & Foley	Mar. 31, 1931	596,100	Dissolved Aug. 17, 1931.
6. Ungerleider Financial Corporation (The Financial Corporation).	S. Ungerleider & Co	Apr. 30, 1931	9,088,700	Dissolved Nov. 6, 1933.
7. Iroquois Share Corporation.	O'Brian, Potter & Stafford.	do	1,441,400	Dissolved Aug. 17, 1931.
8. Federated Capital Corporation.	(Federated Debenture Co., P. H. Whiting Co.).	May 16, 1931	2,845,100	Dissolved July 27, 1935.
9. General Empire Corporation.	Hemphill Noyes Co	June 1, 1931	2,300,000	Dissolved June 21, 1933.
10. Jackson & Curtis Investment Associates.	Jackson & Curtis	July 31, 1931	1,039,600	Dissolved Aug. 17, 1931.
11. Sterling Securities Corporation.	Insuranshares Corporation of New York, et al.	do	16,764,800	Consolidated Oct. 29, 1936.
12. Chatham Phenix Allied Corporation (Sec. Allied Corporation).	Chatham Phenix Corporation.	Aug. 15, 1931	29,412,700	Dissolved Dec. 6, 1931.

[189] Ibid.
[190] Ibid.
[191] Ibid.
[192] Op. cit. supra, note 126, Commission's Exhibits Nos. 1958, 2001.
[193] Ibid.
[194] Ibid.
[195] Id., Commission's Exhibit No. 1958.

TABLE 16.—*Investment trusts and investment companies acquired by Atlas Corporation*—Continued

Investment company	Name of sponsor	Date control acquired by Atlas Corporation	Approximate assets at date of acquisition by Atlas Corporation	Disposition
13. Chain Store Stocks, Inc.	(Shields & Co., E. Naumburg & Co., F. S. Smithers & Co.).	Sept. 16, 1931	$3,407,200	Dissolved Nov. 24, 1933.
14. National Securities Investment Co.	(A. G. Becker & Co., George Pick & Co.).	Sept. 25, 1931	11,243,300	Dissolved July 25, 1935.
15. Aviation Securities Corporation.	(Field Glore & Co., James C. Willson & Co., Mander Investment Co.).	Dec. 31, 1931	1,715,200	Dissolved Nov. 3, 1933.
16. American, British & Continental Corporation.	Blyth & Co	Jan. 6, 1932	6,177,100	Sold to Equity Corporation, 1934.
17. Atlantic Securities Corporation.	(A. Iselin & Co., F. S. Smithers & Co.).	Apr. 30, 1932	1,927,100	Dissolved Dec. 30, 1933.
18 The Goldman Sachs Trading Corporation (Pacific Eastern Corporation).	Goldman, Sachs & Co	Apr. 17, 1933	20,004,800	Consolidated Oct. 29, 1936.
19. Shenandoah Corporation.	(The Goldman Sachs Trading Corporation, Central States Electric Corporation).	Apr. 26, 1933	7,772,700	Do.
20. Blue Ridge Corporation.	Shenandoah Corporation.	Apr. 25, 1933	38,351,200	Sold to American Cities Power & Light Corporation, et al., Nov. 14, 1935.
21. American Investors, Inc.	Tucker, Anthony & Co	June 30, 1933	5,720,100	Dissolved July 16, 1935.

The assets of these companies as of the dates that Atlas Corporation succeeded to their control totaled approximately $172,000,000.[196]

2. ASSET LOSSES SUFFERED BY STOCKHOLDERS OF ACQUIRED COMPANIES

The financial history of these investment companies prior to their acquisition by Atlas Corporation is illustrative of the general experience of most investment companies formed prior to the 1929 securities market collapse. All of the investment companies acquired by Atlas Corporation were formed between 1926 and 1929.[197] A total of approximately $783,000,000 was contributed by the public and sponsors to these companies, of which $24,000,000, or 3% of this total gross contribution, was retained by the sponsors as selling commissions.[198] A total of approximately $159,000,000 was returned to the stockholders of these companies, prior to their acquisition by Atlas

[196] Id., Commission's Exhibits Nos. 1958, 2003.
[197] Id., Commission's Exhibit No. 2003.
[198] Ibid.

Corporation, by way of repurchases of their own outstanding securities and as dividends and interest, paid largely from unearned surplus.[199] Of the approximately $600,000,000 remaining with these companies as net contributions made by their security holders, approximately $420,000,000 (realized and unrealized) had been lost by these investment companies[200] prior to their acquisition by Atlas Corporation. Expressed in percentages, this loss was approximately 70% of the net capital investment in the companies after payment of underwriting commissions, repurchases of their own outstanding securities, and the payment of dividends and interest.[201] Mr. Odlum testified that the losses suffered by these companies prior to Atlas Corporation's acquisition of their control was approximately $42,000,000 greater than would have been suffered if these companies had invested only in the 90 common stocks included in the Standard Statistics Company index.[202]

Although large losses were suffered by the stockholders of these companies, it is doubtful that the net loss suffered by the sponsors of these companies as a class was substantial. It is probable that the capital contributions of the sponsors themselves to these companies did not exceed the underwriting, brokerage, and other commissions derived by the sponsors from these companies.[203] In addition, the sponsors usually held control of the company either by the ownership of a controlling block of its securities or by means of management contracts and option warrants. In other cases, control existed because of the general inertia of the public stockholders. The "control," whatever its source, had the pecuniary characteristic of salability at attractive prices. The purchase of the "control," coupled with an assurance of the continuance of the principal emolument of the previous connection of the sponsor with the company—brokerage commissions—would enable Atlas Corporation to secure the active aid or passive acquiescence of the former sponsors in further acquisition by the Atlas Corporation, by purchases or exchange offers, of additional shares of the acquired company's securities.

The techniques and strategies used by Atlas Corporation in acquiring control of other investment companies and in acquiring the shares of such companies by purchase, or by an exchange offer, of its own securities, will be discussed in later parts of this chapter.[204] However, it may be stated that in the course of its acquisition program, Atlas Corporation purchased common and preferred stocks of its acquired companies from sponsors, directors, and others affiliated with the management of such companies for a total consideration of $20,651,457.07.[205] This sum was $7,044,544.33 in excess of the market value of the securities at the date they were purchased[206] and $461,297.09 in excess of the asset values of the securities at the date they were acquired.[207] In addition, Atlas Corporation paid the sum of $732,-

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[199] Ibid.
[200] Ibid.
[201] Ibid.
[202] Id., at 12090.
[203] See the cases discussed in Sec. III, infra.
[204] See Secs. III and IV, infra.
[205] Op. cit. supra, note 126. Commission's Exhibit No. 1966.
[206] Ibid.
[207] Ibid.

895 [208] for option warrants held by sponsors, directors, and managers of its acquired companies—warrants which apparently then had no actual or potential value. In some cases the purchase of these warrants was conditioned upon the agreement of the sellers to recommend to the stockholders of their companies acceptance of exchange offers of the securities of Atlas Corporation for the securities of the companies controlled by the sellers of the warrants.[209] Usually the warrants when acquired were charged off as worthless on the books of Atlas Corporation or on the books of the acquired companies to which they were transferred by Atlas Corporation.[210]

Atlas Corporation also purchased one management contract and caused one of the investment companies which it acquired to purchase another management contract. The total consideration paid for these two management contracts was $160,000.[211] Finally, the Atlas Corporation paid cash commissions of $200,370 to influential directors and officers of an investment company to recommend exchange offers made by Atlas Corporation for the securities of their company.[212]

In nearly every case the consideration paid by Atlas Corporation for the shares and warrants of the sponsors, managers, and directors of the companies acquired by Atlas Corporation, substantially exceeded the consideration which Atlas Corporation paid either in cash or in its own securities for the shares of its acquired companies held by the public.[213]

Mr. Odlum denied that the considerations to insiders for their holdings of the shares or warrants of the companies acquired and absorbed by Atlas Corporation were paid as an inducement to the sellers to aid Atlas Corporation in the effectuation of its subsequent exchange offer of its securities for the securities of such companies or in its purchase of their securities. He stated that the purchases

[208] Id., Commission's Exhibit No. 1967.

[209] See infra, pp. 1247–58. In the case of Iroquois Share Corporation, O'Brien, Potter & Company, the original sponsors of that company, and Walter F. Stafford, the company's president, were offered warrants of Atlas Corporation having a market value of $50,000 in exchange for Iroquois Share Corporation warrants having no market value, provided the holders of 51% of the stock of Iroquois Share Corporation accepted an exchange offer of Atlas Corporation's securities for such stock. Clearly, this offer of Atlas Corporation's warrants would be a powerful inducement to the sponsors and the president of Iroquois Share Corporation to recommend to its stockholders acceptance of Atlas Corporation's exchange offer. In fact, Walter F. Stafford recommended that the stockholders of Iroquois Share Corporation accept Atlas Corporation's exchange offer. (See Ch. II of this part of the report, pp. 51–75.)

[210] See infra, pp. 1268 and 1276.

[211] As a condition precedent to its agreement to make an exchange offer of its shares for the shares of Iroquois Share Corporation, Atlas Corporation required Iroquois Share Corporation to purchase the contract to manage Iroquois Share Corporation, held by one Walter F. Stafford. Iroquois Share Corporation paid $75,000 to acquire Mr. Stafford's contract. (See Ch. II of this part of the report, pp. 51–75.) Atlas Corporation itself purchased for $85,000 from Federated Management Company that company's contract to manage Federated Capital Corporation.

[212] Op. cit. supra, note 126, Commssion's Exhibit No. 1967; see also the discussion of All American General Corporation, infra, pp. 1324–38.

[213] See the cases of National Securities Investment Company, Atlantic Securities Corporation, Sterling Securities Corporation, Ungerleider Financial Corporation, and Chatham Phenix Allied Corporation, discussed infra, pp. 1094, 1247, 1162, 1230 and 1142, respectively.

were made only for the purpose of acquiring control of the companies involved:[214]

Q. I am just wondering, Mr. Odlum, why you take such meticulous care to eliminate the inference that these purchases of common stock above asset value and above market value and option warrants which were not even remotely exercisable, management contracts which weren't paying, and brokerage business and cash payments, have absolutely no connection with any intent on the part of Atlas Corporation to have these individuals help Atlas Corporation in its exchanges.

A. Well, I take care to do that simply because in principle the idea of acquiring all these blocks was to further our program of getting control of the stock and getting control of the management, of the portfolio. Now, I have readily admitted to you this morning that in the case of All American General that we did pay cash to get people who were in the management, who were on the board of directors of the company, whose stock we were trying to acquire, to actively go out and do footwork for us. * * * But the fundamental [idea] was that we weren't buying help, we were buying stock, and in a way whereby we would not be blocked with big blocks out against us, and we had to have the management in order to complete our program.

Mr. Odlum further testified:[215]

Q. And you say that the option warrants were never purchased with the intent of persuading the influential insiders to assist actively the Atlas Corporation in their exchange program.

A. I would say that the major reasons and objectives in buying option warrants were to get the control and dominating influence out of the management and let us get in. If it had an incidental effect of making them mentally hospitable with us, all well and good, and I certainly would not throw it down for that reason.

However, nearly all of the "insiders" in the companies acquired by Atlas Corporation, in consideration of commissions or other pecuniary benefits, did in fact actively assist Atlas Corporation in the effectuation of its exchange offers of its securities for the securities of its subsidiary companies.[216]

As a result of its expansion program, Atlas Corporation's initial assets of approximately $17,000,000 were increased to approximately $106,589,000 as at February 28, 1937.[217] As at December 31, 1935, the corporation had issued a total of 295,249 shares of its preference stock, 4,259,616 shares of its common stock, and perpetual option warrants to purchase 1,681,072 shares of its common stock at a price of $25 a share.[218] Total capital raised by the issuance of these securities, after giving effect to the retirement of repurchased securities, was approximately $64,000,000.[219] As at December 31, 1935, Atlas Corporation had issued, by way of exchange offer of its securities for the securities of other investment companies, a total of: (a) 195,412 shares of its preference stock, of which 121,035 shares were of original issue, and 74,377 shares had been outstanding and repurchased and re-

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[214] Op. cit. supra, note 126, at 17782–3.

[215] Id., at 17795.

[216] See Secs. III and IV, infra.

[217] Op. cit. supra, note 126, Commission's Exhibit No. 1989.

[218] Id., Commission's Exhibit No. 1957.

[219] Ibid.

issued; and (b) 3,186,391 shares of its common stock, of which 2,932,700 shares were of original issue and 253,691 shares had been repurchased and reissued.[220] Actually, therefore, if repurchased and reissued shares are included, approximately 66% of the total preference stock issued by the corporation was issued by way of exchange for the securities of other investment companies.[221] The securities issued in exchange for the securities of other investment companies accounted for approximately $42,000,000 of the total capital and surplus of $63,798,353.89 which had been contributed to the company as consideration for the issuance of all of its securities as at December 31, 1935.[222] In other words, approximately 67% of the total capital and surplus contributed to the company as at December 31, 1935, was raised by the issuance of the company's securities for the securities of other investment companies.

On October 29, 1936, the acquisition program of Atlas Corporation was finally wound up by the consolidation of Atlas Corporation with its then existing investment company subsidiaries, Pacific Eastern Corporation, Shenandoah Corporation and Sterling Securities Corporation.[223] The consolidation resulted in the acquisition by Atlas Corporation of the assets formerly allocable to the minority stockholders of these subsidiaries.[224] Such assets totaled approximately $20,682,000,[225] and the minority stockholders of these subsidiaries were paid for these assets with 209,455 shares of the consolidated Atlas Corporation's preferred stock and 548,595 shares of its common stock.[226] The effect of the consolidation was to increase the capital and surplus contributed to the enterprise to approximately $83,000,000, of which approximately $62,000,000, or 75%, of the total capital and surplus of the corporation, was the result of its program of investment company acquisitions.[227]

That the expansion program of Atlas Corporation was advantageous to its organizers, who were the arbiters of the conduct of the program and of the extent to which such program was to readjust and realize the rights and values of minority stockholders of acquired companies, is evident from the fact that the 300,000 shares which they had acquired at the inception of the corporation increased in asset value from $8.55 [228] on March 31, 1930, a month prior to the inception of the company's expansion program, to $20.53 per share as of February 28, 1937.[229] The total asset gain on the original 300,000 shares held by the sponsors of the corporation was $3,594,-

[220] Id., Commission's Exhibit No. 1957.

[221] Id., Commission's Exhibit No. 1960.

[222] Id., Commission's Exhibits Nos. 1957, 1989.

[223] Id., Commission's Exhibit No. 1944.

[224] Id., Commission's Exhibit No. 1989.

[225] Ibid.

[226] Derived from supplemental information supplied the Commission for Atlas Corporation.

[227] Op. cit. supra, note 126, Commission's Exhibit No. 1989.

[228] Ibid.

[229] Ibid. From March 31, 1930, to February 28, 1937, the corporation had a gross increase in assets over contributed capital of approximately $67,606,000, a per share gross asset increase of $16.90. However, over the same period the company expended a total of $21,268,000 in the payment of taxes, expenses, and dividends totaling $5,400,000 on the company's preferred stock and $6,000,000 upon the company's common stock. (Ibid.) These deductions reduced the company's net gains from March 31, 1930, to February 28, 1937, to $46,338,000. These disbursements reduced the gross asset value increase of $16.90

000.[230] In addition, the 200,000 units of common stock purchased by Mr. Odlum, pursuant to the terms of his management contract with the corporation, at a total price of $1,300,000, if they were retained by Mr. Odlum, had a total asset value as of February 28, 1937, of approximately $4,106,000.[231] The market value of the 200,000 units as of the same date was approximately $4,200,000.[232]

In contrast to these gains by the sponsors of Atlas Corporation, stockholders of acquired companies who disposed of their shares to Atlas Corporation directly, or who sold their shares below asset value to their own companies during their management by Atlas Corporation, suffered losses measured by the difference between the asset value of their shares and the price which they received for the shares of approximately $7,365,000.[233] Stockholders of acquired companies who exchanged their shares for Atlas Corporation shares suffered a loss in asset value because of the fact that the Atlas Corporation shares received in exchange invariably had a lower asset value than the asset values of the shares transferred to Atlas Corporation. However, the market value of the Atlas Corporation securities offered in exchange usually exceeded the market value of the securities of the other investment securities. The aggregate loss sustained by exchanging stockholders was approximately $12,812,000,[234] measured, as of the date of the exchange, by the difference between the asset value of the shares exchanged by stockholders of acquired companies and the market value of the Atlas Corporation securities received on the exchanges.

However, this loss in asset values was to some extent retrieved by exchange stockholders, since by becoming common stockholders in Atlas Corporation they shared in the gains to Atlas Corporation made on the subsequent exchange offers—gains made by virtue of the losses in assets suffered by stockholders of acquired companies who subsequently exchanged their shares for Atlas Corporation shares. Those stockholders of acquired companies who accepted the earlier exchange offers of Atlas Corporation benefited from gains made by Atlas Corporation on its succeeding exchange offers.

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per share of Atlas Corporation common stock by approximately $4.92. The sources of the gross increase in assets of $67,606,000 were as follows:

	Gross increase in asset value per common share from Mar. 31, 1930
Increase from excess asset value derived on exchange offers for securities of acquired companies	$3.20
Increase from cash purchases at a discount from asset values of securities of acquired companies	1.24
Increase from purchase by acquired companies of their own shares	.60
Increase from purchase by Atlas Corporation of its own securities below asset value	.30
Increase from conversion of Atlas Corporation common stock into preferred stock in October of 1936	.23
Increase from interest and dividend received on securities	1.75
Increase from management fees paid by acquired companies to Atlas Corporation	.52
Profit on sale of Blue Ridge Corporation shares in November 1935	.80
Realized and unrealized profits on "special situations" invested in by Atlas Corporation	1.82
Portfolio appreciation	6.44
	$16.90

[230] Id., Commission's Exhibit No. 1989.

[231] Ibid.

[232] Ibid.

[233] Ibid.

[234] Ibid.

The record indicates that approximately 85% of the total gains derived by Atlas Corporation as the result of its expansion program accrued to stockholders of acquired companies who had exchanged their securities for Atlas Corporation securities, and 15% of these gains accrued to the original stockholders of Atlas Corporation.[235]

Manifestly, stockholders accepting the exchange offers underwent a readjustment of their rights and status. Immediate losses in asset value were suffered; preferred stockholders of acquired companies became common stockholders of Atlas Corporation or became preferred stockholders of Atlas Corporation with rights and privileges different from those previously possessed. Common stockholders of acquired companies may have become preferred stockholders of Atlas Corporation or warrant holders of Atlas Corporation. These important changes were effected without any regulation or supervision of any governmental agency.[236] Mr. Odlum testified that in his opinion the Atlas Corporation acquisition program was beneficial to the stockholders of the investment companies acquired by the Atlas Corporation for the reasons that (a) stockholders who sold their shares for cash to Atlas Corporation obtained a price which, although less than the asset value of the shares, was in excess of market value of these shares or comparable investment company shares; (b) stockholders who exchanged their shares received Atlas Corporation securities which had a better marketability than the shares of the acquired companies and received a participation in a larger, more active, and better managed investment company.[237]

However, Mr. Odlum, when examined on this exchange program, testified:[238]

* * * I would like to add this for the record—that it is a poor man who doesn't gain knowledge as he grows older. I am some seven years older today than I was when we started this investment trust acquisition program, and there were many things that we did in the way of technique, mechanics, and methods that today, based on experience, I would probably not do the same way. That goes even to fundamentals, and purely from the standpoint of the good to my own stockholders I think I gave more effort to the process of acquisition of trusts than should have been given for the profits obtained. The same effort devoted to standard methods of operation would have given as good, if not better, results.

When examined on the economic function of this expansion program of Atlas Corporation, Mr. Odlum testified:[239]

Q. As far as any economic function is concerned, if we were to take a broad view of it, you became a distributor of wealth in this country and took so much money from A and gave it to his * * * fellow stockholder B; isn't that so?

A. Well, we tried to give it to our original stockholders, and it worked out that they were only able to keep about 15%.

Q. No money was made. It was just taken from Peter and given to Paul?

A. I am not saying any economic function was served by any investment trust.

Q. You are not the only one who has expressed that skepticism or doubt.

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[235] Id., at 18030.

[236] For a discussion of the techniques used by Atlas Corporation and others to acquire and absorb the assets of investment companies, see infra, Secs. III and IV.

[237] Op. cit. supra, note 126, at 17719, 17721–2.

[238] Id., at 18262.

[239] Id., at 18030.

A. Yes.

Q. That exchange program did not raise new capital, did not put new money in pathological situations; isn't that so?

A. That is true.

* * * * * * *

Q. But as far as making any contribution to the wealth of the nation, that is not exemplified by a broad exchange program, because all you did (and you were the arbiter as to how it was done) was to take it from Paul and give it to Peter, and in the transaction the original stockholder, yourself and colleagues, got their compensation for doing that in the form of 15%.

A. I was trying to make money for my stockholders in a fair way, and they hung on to a little of it.

Q. That is in the nature of an exchange. In the case of repurchases at a discount certainly the same argument is applicable?

A. I don't believe there was any economic function served in any of them.

Q. * * * in the exchange program, at least the individual became a stockholder of Atlas and got his pari passu share of the increment; isn't that so?

* * * * * * *

And in the case of purchases at a discount that was not even true, because when you purchased the stock of the preferred stockholder of National Securities Investment Company he did not even become a stockholder of Atlas, so that he did not get any share in the gain to Atlas.

A. No; we just gave him a better market than he would have had otherwise.

Q. Of course, in this better market situation, Mr. Odlum, he may have held his preferred stock if it wasn't for the fact the sponsor was actively soliciting his preferred stock and telling him to sell it, and you might conceive of situations where individuals relied upon their sponsors, officers, and directors, and people who originally sold the stock and took their advice?

A. Yes; he may have kept the preferred stock, and if he had kept the preferred stock he would be in exactly the position we were; and some did keep it, and they got exactly what we got.

D. Fiscal Management and Northern Fiscal Groups [240]

1. ACTIVITIES OF FISCAL MANAGEMENT GROUP

In August 1937, a group of individuals, including Philip A. Frear, George H. Clayton, Jr., Vincent Ferretti, and others (working through a personal holding company known as the Fiscal Management Company, Ltd.), hereafter referred to as the Fiscal Management group, devised a plan whereby they could obtain control of various investment companies without the expenditure of any of their own funds. In essence, their scheme was to contract to buy a controlling block of stock of an investment company; to pay for this block of stock with funds borrowed on the portfolio securities of the very investment company to be acquired; to take control of the investment company and immediately liquidate the portfolio securities in order to raise the cash needed to pay off the loan; to transfer the controlling block of stock to the Fiscal Management Company, Ltd., their personal holding company; to reimburse the investment com-

[240] A more detailed description of the activities of these groups in the acquisition of control of investment companies, together with the appropriate references to the record, is contained in Ch. II of this part of the report, pp. 350–496.

pany for its portfolio securities sold by transferring to the investment companies preferred stock of the Fiscal Management Company, Ltd., and other securities of doubtful value; and to take in connection with these transactions substantial commissions and profits. Having once acquired control of an investment company the group used the funds of this company to acquire control of other investment companies. As a result of these transactions, these individuals, besides taking substantial commissions and profits, obtained control of a top company of a pyramided system of investment companies without the investment by them of any funds.

The first investment company to be acquired by the Fiscal Management group was First Income Trading Corporation, which had total assets of approximately $540,000. On August 5, 1937, Harold B. Grow, Albert S. Wicks, and their associates contracted to sell all of their Class A management stock (the sole voting stock) of First Income Trading Corporation which they had acquired at a nominal cost. The Fiscal Management group borrowed $110,000, the purchase price of the control stock of First Income Trading Corporation, from the brokerage firm of Paine, Webber & Company, members of the New York Stock Exchange, and turned over to that firm portfolio securities of the investment company which had cost $182,500. Paine, Webber & Company sold these securities in the market for $152,000, deducted its advance of $110,000, and turned over the $42,000 balance of the proceeds to the members of the Fiscal Management group, who retained this balance as their "commissions" or "profit" on the deal. The group then transferred the control block of stock to their personal holding company, Fiscal Management Company, Ltd., a Canadian corporation, and received 1,825 shares of $100 preference stock and 19,995 shares of common stock (all the outstanding common) of Fiscal Management Company, Ltd. The portfolio securities of First Income Trading Corporation sold by the group were replaced with the 1,825 shares of the preferred stock of Fiscal Management Company, Ltd., which then had as its only asset the Class A management stock of First Income Trading Corporation. As a result of these transactions, the members of the group made a "profit" of $42,000 and acquired indirect control of First Income Trading Corporation through their control of Fiscal Management Company, Ltd., which controlled First Income Trading Corporation. The remaining portfolio securities of First Income Trading Corporation were subsequently liquidated by the group and the funds derived were used: (a) to purchase securities of Barkley-Grow Aircraft Corporation, a company with which Mr. Grow was associated; (b) to make personal advances to Messrs. Grow and Wicks; (c) to make loans to associates of the members of the Fiscal Management group; and (d) to purchase from Mr. Clayton and others securities of dubious value. Subsequently, First Income Trading Corporation was taken over by the Michigan State Securities Commission for liquidation.

The second investment company to be acquired by the Fiscal Management group was Continental Securities Corporation. On October 25, 1937, J. Henry Schroder Banking Corporation, the sponsor, manager, distributor of the securities of, and owner of approximately 26,000 shares, or 44%, of the outstanding common stock of Continental Securities Corporation, contracted to sell this stock plus an

additional 3,000 shares, at $20 a share for a total of $580,000, ostensibly to one Alexander Beverly, a member of the Fiscal Management group. The net capital contributed to Continental Securities Corporation, during the management period of J. Henry Schroder Banking Corporation, after giving effect to repurchases and dividends, amounted to $6,000,000, whereas the net assets at October 1937 amounted to $3,300,000. At the time of sale the common stock, which had originally cost J. Henry Schroder Banking Corporation $430,000, had a negative asset value, and all of the assets of the Continental Securities Corporation "belonged" to the holders of its debentures and preferred stock. The Fiscal Management group borrowed the $580,000, the purchase price of the control block of Continental Securities Corporation, from Paine, Webber & Company and turned over to that firm the portfolio securities of the investment company. Paine, Webber & Company sold portfolio securities with a market value of $850,000; deducted its advance of $580,000; turned over approximately $114,000 to members of the Fiscal Management group, which they retained as their "commission"; and turned over the balance of $156,000 to Continental Securities Corporation. The group then transferred this control stock of Continental Securities Corporation to Fiscal Management Company, Ltd., and received 7,000 shares of that company's preferred stock. The portfolio securities of Continental Securities Corporation sold by the group were replaced with 7,000 shares of the $100 preference stock of Fiscal Management Company, Ltd., which then had as its only assets the Class A management stock of First Income Trading Corporation (with a nominal asset value) and the control stock of Continental Securities Corporation (with a negative asset value). As a result of these transactions, the members of the group not only made a "profit" of $114,000 but acquired indirect control of Continental Securities Corporation through Fiscal Management Company, Ltd. The remaining portfolio securities of Continental Securities Corporation were subsequently liquidated and the proceeds used: (a) in an attempt to purchase collateral notes of the South American Utilities Corporation, a venture with which Alexander Beverly was associated; (b) to make personal advances to the New York Stock Exchange brokerage firm of Prentice & Brady, which was associated with the Fiscal Management group; (c) to make loans to members and associates of the group; (d) to purchase control of Corporate Administration, Inc., which controlled Administered Fund Second, Inc., an open-end investment company; and (e) to purchase control of Reynolds Investing Company, Inc., another investment company. In March 1938, proceedings were instituted to reorganize the Continental Securities Corporation under Section 77-B of the Bankruptcy Act.

The third company to be acquired by the Fiscal Management group was Corporate Administration, Inc. In November 1937, Gilbert Ottley and Robert Strange, who had organized Corporate Administration, Inc., which in turn had sponsored, managed, and distributed the securities of Administered Fund Second, Inc., an open-end investment company, contracted to sell to the Fiscal Management group for $250,000 the entire common stock of Corporate Administration, Inc. The only asset of Corporate Administration, Inc., was its management and distributing contract with Administered Fund Second, Inc.,

upon which contract Mr. Strange and Mr. Ottley had up to that time sustained substantial losses. The Fiscal Management group caused Continental Securities Corporation, which the group controlled, to acquire this control stock of Corporate Administration, Inc., for $354,000, of which amount $250,000 was paid to Mr. Ottley and Mr. Strange, and the balance was retained by the members of the group as "commissions" or "profits" on the deal. The assets of Administered Fund Second, Inc., which was controlled by Corporate Administration, Inc., were not disturbed by the Fiscal Management group, apparently because of the charter restrictions relating to the investment policy of Administered Fund Second, Inc. In August 1937, the control block of stock of Corporate Administration, Inc., was sold by the trustee in reorganization of Continental Securities Corporation for $5,000, or at a loss of $349,000 to Continental Securities Corporation.

The fourth investment company to be acquired by the Fiscal Management group was Reynolds Investing Company, Inc. On December 31, 1937, the C. K. Reynolds family, who had sponsored, distributed the securities of, managed, and controlled the Reynolds Investing Company, Inc., contracted to sell approximately one million shares, a controlling block, of the common stock of that company for approximately $2,100,000 to Sartell Prentice, a partner in the brokerage firm of Prentice & Brady. The net capital contributed to Reynolds Investing Company, Inc., after deductions for repurchases and dividends, during the management period of the Reynolds family, amounted to approximately $12,000,000, while assets amounted to $5,000.000 at December 1937. At the time of sale the common stock, which had originally cost the Reynolds family approximately $1,000,000, had an asset value of 4 cents a share, or a total asset value of only approximately $40,000. Sartell Prentice was, in fact, however, only the ostensible purchaser, since the Fiscal Management group was causing Continental Securities Corporation, which the group controlled, to purchase control of Reynolds Investing Company, Inc. Continental Securities Corporation paid on this contract a total of $1,900,000 with the proceeds derived from the liquidation of its portfolio securities. The balance of approximately $200,000 was furnished by First Income Trading Corporation, controlled by the group. Approximately $900,000 of the funds needed by Continental Securities Corporation was raised by its sale of its block of 8,825 shares of preferred stock of Fiscal Management Company, Ltd., to Reynolds Investing Company, Inc. In May 1938 the debenture holders of Reynolds Investing Company, Inc., instituted proceedings for the reorganization of that company under Section 77 B of the Bankruptcy Act.

2. ACTIVITIES OF NORTHERN FISCAL GROUP

Commencing in December 1937, a group of individuals (working through their personal holding company known as the Northern Fiscal Corporation, Ltd.) started an independent program similar to that used by the Fiscal Management group to acquire control of various investment companies. This group, hereinafter referred to as the Northern Fiscal group, included S. Leo Solomont, Ralph H. Robb, and Thomas W. Morris, who had been associated with the Fiscal Management group in their acquisition activities.

The first investment company acquired by the Northern Fiscal group was Insuranshares Corporation of Delaware.[241] On December 21, 1937, Harry M. Blair, chairman of the board of directors of Insuranshares Corporation of Delaware, contracted to sell 78,260 shares of the common stock of Insuranshares Corporation of Delaware to the Northern Fiscal group for a total of $310,000. The net capital contributed to Insuranshares Corporation of Delaware had depreciated under various managements from approximately $14,000,000 to $800,000, the result of the dissipation of its assets by a group which had acquired control of the investment company in 1932 by methods almost identical with those used by the Northern Fiscal group. The Northern Fiscal group borrowed the $310,000, the purchase price of the stock of Insuranshares Corporation of Delaware, from the brokerage firm of Paine, Webber & Company and turned over to that firm portfolio securities of the investment company with a market value of $500,000. Paine, Webber & Company sold these securities, deducted its advance of $310,000, and turned over a balance of $152,000 to the members of the group. The group then transferred the stock of Insuranshares Corporation of Delaware to their personal holding company, the Northern Fiscal Corporation, Ltd., a Canadian corporation specifically organized in connection with the group's acquisition program, and received 5,000 shares of $100 preference stock of Northern Fiscal Corporation, Ltd. The portfolio securities of Insuranshares Corporation of Delaware sold by the group were replaced with the 5,000 shares of the preferred stock of the Northern Fiscal Corporation, Ltd., which then had among its assets the block of stock of Insuranshares Corporation of Delaware. In June 1938 Insuranshares Corporation of Delaware was placed in receivership.

The second investment company acquired by the Northern Fiscal group was Bond and Share Trading Corporation. In January 1938, Frank B. Erwin and William A. Gutekunst, who had sponsored and managed Bond and Share Trading Corporation, contracted to sell to Insuranshares Corporation of Delaware blocks of Class A stock and Class B stock of Bond and Share Trading Corporation, representing a controlling interest in that investment company, for a total consideration of $153,000. The net contributed capital of Bond and Share Trading Corporation had depreciated during the management period of Mr. Erwin and Mr. Gutekunst from $313,000 to $232,000. Although the contract was signed by Insuranshares Corporation of Delaware, the Northern Fiscal Corporation, Ltd., paid for the stock with its uncertified check of $131,000, drawn to the order of Insuranshares Corporation of Delaware, and $22,000 in cash. This uncertified check was endorsed by Insuranshares Corporation of Delaware to Mr. Gutekunst and his associates, who in turn endorsed the check to Bond and Share Trading Corporation. For this endorsement Mr. Erwin and Mr. Gutekunst received from Bond and Share Trading Corporation about half the portfolio securities of Bond and Share Trading Corporation, valued at $131,000. As a result of these transactions, Mr. Erwin and Mr. Gutekunst were paid for the control stock of Bond and Share Trading Corporation by the delivery to them of over one-half the portfolio securities of Bond and Share Trading Corporation.

[241] For a more detailed description of the acquisition of Insuranshares Corporation of Delaware by the Northern Fiscal group see infra, pp. 1225–30.

The group transferred the control block of stock of Bond and Share Trading Corporation to Northern Fiscal Corporation, Ltd., in satisfaction of the debt created by the issuance of the $131,000 check by Northern Fiscal Corporation, Ltd. Bond and Share Trading Corporation then transferred the $131,000 check which it received for the more than one-half of its portfolio securities transferred to Mr. Erwin and Mr. Gutekunst, plus $44,000 in cash, to Insuranshares Corporation of Delaware in consideration of the transfer to Bond and Share Trading Corporation by Insuranshares Corporation of Delaware of 1,750 shares of the $100 preferred stock of Northern Fiscal Corporation, Ltd. Insuranshares Corporation of Delaware then transferred the $131,000 check and the $44,000 in cash to Northern Fiscal Corporation, Ltd., in consideration of the transfer to Insuranshares Corporation of Delaware of the control block of stock of Bond and Share Trading Corporation. As a result of these transactions Northern Fiscal Corporation, Ltd., not only received back its $131,000 check but also $44,000 in cash derived originally by Bond and Share Trading Corporation from the liquidation of its portfolio securities; and Bond and Share Trading Corporation was controlled by Insuranshares Corporation of Delaware, which in turn was controlled by Northern Fiscal Corporation, Ltd. Bond and Share Trading Corporation, in lieu of approximately three-fourths of its original portfolio, had 1,750 shares of the preferred stock of Northern Fiscal Corporation, Ltd.

The last investment company to be acquired by the Northern Fiscal group was Burco, Inc. On March 3, 1938, Carroll E. Gray, Jr., who owned 36,000 shares, or 38%, of the outstanding common stock of Burco, Inc., contracted to sell this block of stock to the Northern Fiscal group for a total of $340,000. The assets of Burco, Inc., had depreciated from the time of its organization from approximately $2,300,000 to $1,250,000. At the time of sale this block of common stock, which had originally cost Mr. Gray $158,000, had a negative asset value, and all of the assets of Burco, Inc., "belonged" to the holders of its preferred stock. The Northern Fiscal group borrowed $290,000 from Paine, Webber & Company, supplying $50,000 of their own funds, to pay the purchase price of the block of Burco, Inc., stock, and turned over portfolio securities of Burco, Inc., with a market value of $750,000. Paine, Webber & Company sold part of these securities, deducted its advance of $290,000, and turned over the balance of the cash and the unsold portfolio securities to Burco, Inc., which in turn transferred them to one Howard F. Hansell, Jr., a member of the Northern Fiscal group, who had in the meantime sold to Burco, Inc., for $750,000, 25,000 shares of the common stock of Insuranshares Corporation of Delaware and 325,000 shares of the common stock of Delta Oil Company, Ltd., which were of doubtful value. In June 1938, Burco, Inc., was placed in receivership.[242]

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[242] Various criminal proceedings which were instituted in connection with the activities of the Fiscal Management group and Northern Fiscal group are: indictments by the Grand Jury, County of New York, of Messrs. Frear, Ferretti, Clayton, Solomont, Robb, and Morris for grand larceny (all of these defendants, except Mr. Robb, who pleaded guilty, were acquitted on June 9, 1939) and indictments by the Federal Grand Jury for the Southern District of New York of members of the Fiscal Management group and Northern Fiscal group and various others, including Stephen Paine, as alleged participants in a conspiracy to use the mails to defraud. Stephen Paine and the members of the Northern Fiscal group were convicted. The indictment against the members of the Fiscal Management group is still pending.

III. ACQUISITION OF CONTROL AND MANAGEMENT SUPPORT

A. Payment of Finder's Fees

The "finding" of investment companies susceptible of acquisition was, of course, the first task which confronted the acquiring corporations. However, so pronounced was the bartering of control of investment companies after 1929 that certain individuals were regularly engaged in the business of acting as brokers in the sale of control of investment companies. Morton H. Fry, the president of Overseas Securities Co., Inc., testified, in connection with the attempt of the Fiscal Management group to acquire control of his investment company in the latter part of 1937, that he was so frequently approached by "finders" that he "finally began to feel as though I ought to have a bodyguard."[1] Lansing McVickar, an employee of Burr & Co., Inc., a New York investment banking firm, who acted as the "finder" of Continental Securities Corporation for the Fiscal Management group in September 1937, testified that he began to specialize in "finding" investment companies in 1937,[2] and further testified:[3]

Q. But it seems to me from all of the testimony that about this time the financial district evidently was swarming with people who were finders looking for investment trusts, to buy and sell; is not that so?

A. Yes; I believe that is true.

The majority of companies acquired by Atlas Corporation were "found" by "self-constituted" finders "who made it their job" for a commission to bring together Atlas Corporation and sponsors desirous of transferring control of their investment companies. Mr. Odlum testified:[4]

Q. * * * Did you have finders to go out to find the investment trusts that you ultimately acquired?

A. We didn't have finders. They were self-constituted finders in the majority of cases. In a few of the cases the investment trusts came to us by way of their sponsors. In a few of the cases we, through our own organization, went out to establish the contact. In the majority of cases some third party who was making it his job to try to earn a commission brought the thing in to us after having established such contact with the other side as led him to believe that he controlled the business.[5]

Atlas Corporation paid a total in "finder's" fees of approximately $1,407,900.[6] The largest single fee was $100,000 paid to E. F. Hutton

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[1] Public Examination, First Income Trading Corporation et al., at 439.

[2] Id., at 937–8.

[3] Id., at 939.

[4] Public Examination, Atlas Corporation, at 17786–8.

[5] Mr. Odlum also testified (ibid.):

In the following companies they [the sponsors or managers] came to us: All America General; Allied Atlas; National Securities Investment; Widlor; Power & Light Securities; Selected Stocks; and Walhardt. In the following companies the matter was handled by an intermediary: American, British & Continental; Atlantic Securities; Aviation Securities; Chain Store Stocks; Federated Capital; General Empire; Iroquois Share; Jackson & Curtis; Sterling Securities and Ungerleider.

* * * * * * *

The following companies have no classification: American Investors; Blue Ridge; Pacific Eastern; Shenandoah * * *.

[6] Public Examination, Atlas Corporation, at 17793 and Commission's Exhibit No. 1909.

& Co. for its services in bringing together the officers of Atlas Corporation and the management of Chatham Phenix Allied Corporation,[7] of which E. F. Hutton was a director.[8] David G. Baird, a partner of Marsh & McLennan, insurance brokers, received approximately $70,000 in fees for his aid in "finding" Chain Store Stocks, Inc., and Chatham Phenix Allied Corporation.[9] D. M. S. Hegarty, of Hegarty & Conroy, New York brokers, received total "finder's" fees of $59,878 for his services in connection with the acquisition by Atlas Corporation of control of Atlantic Securities Corporation, Chain Store Stocks, Inc., General Empire Corporation, Iroquois Share Corporation, and Jackson & Curtis Investment Associates.[10]

Similarly The Equity Corporation paid to Distributors Group, Inc., of which Chase Donaldson was president, a fee of $62,500 for its services in inducing Atlas Corporation to transfer its interest in Reliance International Corporation to The Equity Corporation;[11] a fee of $25,000 to Distributors Group, Inc., for its services in connection with the transfer of control of American, British & Continental Corporation by Atlas Corporation to The Equity Corporation;[12] and a finder's fee of $25,000 to Allied-Distributors, Inc., a company controlled by Chase Donaldson (who was then a director of The Equity Corporation), for its services in connection with the acquisition of control by The Equity Corporation of Eastern Shares Corporation.[13]

The sum of $102,703 was paid as finder's fees in connection with the acquisition of control by Fiscal Management Company, Ltd. of First Income Trading Corporation, Continental Securities Corporation, Corporate Administration, Inc. (which controlled Administered

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[7] Id., Commission's Exhibit No. 1969.

[8] Public Examination, Chatham Phenix Allied Corporation, Commission's Exhibit No. 1589.

[9] Mr. Baird received $59,046.25 as a "finder's" fee for bringing Chatham Phenix Allied Corporation to Atlas Corporation, and $10,000 for Chain Store Stocks, Inc. (Public Examination, Atlas Corporation, Commission's Exhibit No. 1969).

[10] Mr. Hegarty received $15,000 on the Atlantic Securities Corporation transaction, $4,500 on Chain Store Stocks, Inc., $8,378 on General Empire Corporation, $27,000 on Iroquois Share Corporation, and $5,000 on Jackson & Curtis Investment Associates (Public Examination, Atlas Corporation, at 17788–90).

[11] Public Examination, The Equity Corporation, Commission's Exhibit No. 793 (annual report to stockholders of Distributors Group, Inc., December 31, 1934). Chase Donaldson testified that this figure was based on the price at which Reliance International Corporation was selling on the market, that is $2.50 per share (id., at 8489). Chase Donaldson received initially, as commission for the Reliance International Corporation transaction, 25,000 shares of the Class A stock of Reliance International Corporation for which he paid only $1,000, which covered the amount of the transfer tax (id., at 8481). In January 1935 these shares were sold to Group Assets, Inc., a company which owned stock beneficially for The Equity Corporation (id., at 8484), for $55,000, and in consideration for which they purchased 40,000 shares of the common stock of The Equity Corporation. On June 10, 1935, Distributors Group, Inc., repurchased from Group Assets, Inc., the 25,000 shares of Reliance International Corporation Class A stock and sold Group Assets, Inc., 40,000 shares of the common stock of The Equity Corporation for $55,000. On the same day Distributors Group, Inc., exchanged the 25,000 shares of the Reliance International Corporation Class A stock for 25,000 shares of the common stock of The Equity Corporation and received, in addition, a commission of $22,500 from The Equity Corporation for the American, British & Continental Corporation transaction (id., at 8490), for which Distributors Group, Inc., was given an option and did finally purchase 15,000 shares of the common stock of The Equity Corporation. As a result, Chase Donaldson testified that he derived as his commission on the Reliance International Corporation and American, British & Continental Corporation deal a commission of a total of 40,000 shares of common stock of The Equity Corporation (id., at 8495).

[12] Public Examination, The Equity Corporation, at 8494; see also note 11, supra.

[13] Public Examination, The Equity Corporation, Commission's Exhibit No. 790, p. 23.

Fund, Second, Inc.), and Reynolds Investing Company, Inc. Lansing McVickar and Burr & Co., Inc., jointly received $37,703 [14] for their services in connection with the group's acquisition of control of Continental Securities Corporation. Franklyn E. Mayer and Thomas D. Conroy jointly received $20,000 [15] for their services in connection with the acquisition of control of Corporate Administration, Inc., which controlled Administered Fund, Second, Inc. Mr. Conroy, Mr. Mayer, and others received $40,000 [16] as "finder's" fees in connection with the acquisition of Reynolds Investing Company, Inc., by the group.

Similarly, the Northern Fiscal group, headed by Messrs. Robb, Morris, and Solomont, who, as has been already indicated, acquired control, through Northern Fiscal Corporation, Ltd., of Insuranshares Corporation of Delaware, Bond and Share Trading Corporation, and Burco, Inc., paid as "finder's" fees a total of $20,000 [17] to Francis X. Mancuso and Lorimer Davidson, jointly, for their services in connection with the acquisition of control of Insuranshares Corporation of Delaware and Bond and Share Trading Corporation. For their services in "finding" Burco, Inc., Lansing McVickar was paid $11,000 [18] and Lorimer Davidson $6,800.[19]

Ultimately, these "finder's fees" paid by acquiring corporations or individuals were recouped out of the profits derived in the acquisition by purchase or exchange offers of the securities of acquired companies for a consideration less than the actual asset value of such securities, as was the case in Atlas Corporation and The Equity Corporation, or from profits derived by self-dealing with the assets of the acquired companies, as in the case of the group of investment companies acquired by the Fiscal Management group. In other words, the "finder's fees" and other costs of acquisition were ultimately in effect paid by stockholders of acquired companies.

B. Necessity for Support of Management and Control of Companies To Be Acquired

Control of the investment company to be acquired was a necessary prerequisite to the successful consummation of the purpose of the acquiring corporation or individual, whether such purpose was to deal with the corporate assets directly for the acquirer's own benefit or to acquire the securities of the company at discounts from their actual asset value, either by purchase or by an exchange offer. In the latter case, control of the management of the corporation would give the purchaser, or prospective purchaser, supervision of the acquired investment company's portfolio, and thereby enable it to protect its gains in asset values on subsequent purchases or exchange offers for the securities of the controlled company. A drop in portfolio values might erase the asset gains on exchange offers for, or market purchase of, the securities of controlled companies.[20] Fur-

[14] Public Examination, First Income Trading Corporation, et al., at 936.

[15] Id., at 1291–2.

[16] Id., at 1380–1.

[17] Id., at 799–800.

[18] Id., at 948.

[19] Id., at 810.

[20] As Mr. Odlum, the president of Atlas Corporation, testified (op. cit. supra, note 4, at 11722–3): "* * * it was indispensable that Atlas acquire the control of the portfolio so that it could be liquidated and saved from a further fall in the market."

ther, control of the portfolio would enable the acquirer to pyramid the process of acquisition by using the funds of one acquired investment company to acquire the securities of other investment companies eventually to be absorbed. Control of the corporation also meant access to the lists of its stockholders, a necessary preliminary to the successful prosecution of cash purchases or exchanges of the securities of the controlled company.

Of greater importance was the possibility, unless the good will of the existing controlling interest was acquired, of resistance by such interests to cash purchases and exchange offers made by the acquiring investment companies. The existing management might compete with the acquiring corporation in the purchases of shares or cause the corporation to purchase its own outstanding shares with a consequent increase in the market value of the shares. Circularization of stockholders with letters condemning or opposing the exchange offers might be undertaken by the existing management.[21]

1. ATTEMPTED ACQUISITION OF CONTROL OF NATIONAL INVESTORS CORPORATION BY ATLAS CORPORATION

The failure of the attempt of Atlas Corporation to acquire National Investors Corporation, Second National Investors Corporation, Third National Investors Corporation, and Fourth National Investors Corporation, is illustrative of the necessity for management support for the successful consummation of the acquisition of control of an investment company.

National Investors Corporation was organized under the laws of New York[22] in June 1927 and was sponsored by the Guardian Detroit Company, the National Shawmut Bank of Boston, and Fred Y. Presley.[23] In 1928, National Investors Corporation sponsored Second National Investors Corporation, incorporated under the laws of Delaware, which it managed under the terms of a management contract.[24] In 1929, National Investors Corporation caused the incorporation of Third National Investors Corporation and Fourth National Investors Corporation, both of which it also managed pursuant to management contracts.[25] National Investors Corporation in 1931 controlled about one-third of the outstanding stock of Second National Investors Corporation[26] and 10% of the outstanding capi-

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[21] In fact, as described hereafter, in the first attempt of Atlas Corporation to acquire control of an investment company (All America General Corporation), its direct exchange offer was met with active resistance from a majority of the directors of the company sought to be acquired. Only by payment of commissions to influential directors of the company for their advocation of the exchange offer was that particular acquisition made successfully. Mr. Odlum testified (Public Examination, Atlas Corporation, at 17769–70):

> Q. But you did learn from your first experience, however, that the dominant personalities could be of material assistance in an exchange program?
> A. That, in fact, yes, if you had the dominant personalities fighting you, it made a very difficult job and one that you had better never touch.

See infra, pp. 1324–37, for a discussion of the acquisition of control of All America General Corporation by Atlas Corporation.

[22] Public Examination, National Investors Corporation, at 4256.

[23] Id., at 4271.

[24] Id., at 4274.

[25] Id., at 4295.

[26] Id., at 4279. National Investors Corporation purchased 100,000 shares of the 300,000 shares of authorized common stock of Second National Investors Corporation and all of the option warrants for $1,000,000 (id., at 4284, 4310).

tal stock of Third National Investors Corporation.[27] National Investors Corporation also acquired warrants to purchase 750,000 shares of the capital stock of Fourth National Investors Corporation.[28] These warrants if exercised would have placed National Investors Corporation in majority control of Fourth National Investors Corporation.

Obviously, control of National Investors Corporation would also assure control of Second National Investors Corporation, Third National Investors Corporation, and Fourth National Investors Corporation. Total assets owned by the National Investors group of investment companies as at December 31, 1931, valued at market prices, aggregated approximately $25,000,000.[29]

In 1931, National Investors Corporation had outstanding 14,858 shares of $100 par value preferred stock and 860,999 shares of common stock including 75,000 shares held in the treasury of the corporation.[30] The common stock had no asset value, the total assets of the company being insufficient to cover the liquidating value of the preferred stock outstanding.[31]

On July 10, 1931, Atlas Corporation approached the executive committee of National Investors Corporation with a proposal to purchase, at the market price, 75,000 shares of the common stock of National Investors Corporation then in the treasury of the company,[32] and which then had no asset value.[33] Similar proposals were made for the purchase of shares of the common stock of National Investors Corporation's affiliated investment companies.[34]

The executive committee of National Investors Corporation, being of the opinion that these proposed purchases to be made by Atlas Corporation were not intended as investments but as a "stepping stone" to obtain control of National Investors Corporation and its affiliated investment companies, rejected Atlas Corporation's proposals.[35]

Thereafter, Atlas Corporation began to accumulate in the market the preferred and common stocks of National Investors Corporation and its affiliated companies.[36] By the fall of 1931, Atlas Corporation had accumulated 75,000 shares of National Investors Corporation common stock.[37] By 1933, Atlas Corporation had accumulated about 160,000 shares of National Investors Corporation common stock; 25,000 war-

[27] Id., at 4301. National Investors Corporation purchased 20,000 shares of the authorized 200,000 shares of common stock and 200,000 of the option warrants of Third National Investors Corporation for $1,000,000 (ibid.).

[28] Id., at 4317.

[29] *Moody's Manual of Investments, Banks, etc.*, 1932, pp. 412–15.

[30] Id., at 412.

[31] The 14,858 shares of preferred stock were entitled on liquidation to $110 per share, or a total of $1,634,380, and were in arrears in dividends $8.25 per share, or a total of $122,578.50. The net assets of National Investors Corporation at the time were $1,520,213. Thus, the assets of the company would have had to increase by $236,745.50 before there would be sufficient assets to cover the liquidating value of, and the dividend averages on, the preferred stock.

[32] Op. cit. supra, note 22, at 4518.

[33] Id., at 4518–9.

[34] Id., at 4518. In addition, Mr. Odlum was desirous of becoming a member of the board of directors of First, Second, Third, and Fourth National Investors Corporation (ibid.).

[35] Id., at 4519.

[36] Id., at 4521–24.

[37] Id., at 4522.

rants for the purchase of the common stock of National Investors Corporation; 17,000 shares of the preferred stock of Second National Investors Corporation, out of a total of 83,000 shares outstanding; 52,000 shares of the common stock of Third National Investors Corporation, out of a total of 220,000 shares outstanding; and a "small amount" of the common stock of Fourth National Investors Corporation.[38]

Efforts were made by Mr. Odlum to obtain the cooperation of Fred Y. Presley, the president of National Investors Corporation and its affiliated companies, in the further acquisition by the Atlas Corporation of the stock of the National Investors companies. Mr. Presley testified that he refused to support Atlas Corporation in any exchange offer for the shares of his companies which would result in a loss in asset value to his stockholders:[39]

A. I mean by the basis of exchange in the acquisition of investment trusts in the past, exchange of Atlas stock on an approximate market price basis with the shares of other investment trusts on an approximate market basis with at times giving some slight edge on the market price basis to the stockholder exchanging his security for Atlas common stock. In the numerous instances of acquisitions of that type Atlas had gained substantially in asset value, because the market price of Atlas was at or above asset value, usually, although I think it did sell at a discount at times, whereas the shares acquired in exchange for Atlas stock were very substantially below the asset value.

Q. Was that the situation regarding Atlas stock and National at that time?

A. It was particularly accentuated at that time. The market price of our shares in relation to asset value were very much depressed; whereas the shares of Atlas were selling at or above asset value.

* * * * * * *

We met a few days later and he thought I should cooperate with him in the acquisition of the company.

A. I told him [Mr. Odlum] that if he was prepared to offer Second, Third, and Fourth shareholders dollar for dollar in asset value on an exchange basis I would not oppose him, but I was not at all sure that I would support him. On the other hand, I told him if he made an offer on a market value basis I would fight it out with him with the public.

As a result of this opposition by Mr. Presley to its program, Atlas Corporation agreed to withdraw from the situation by selling its holdings of stock of the National Investors Corporation group back to the respective companies,[40] with the exception of the 165,000 shares of National Investors Corporation common stock which Atlas Corporation, however, according to Mr. Presley, agreed to sell gradually in the market.[41] Atlas Corporation's holdings of Second National Investors Corporation and Third National Investors Corporation stocks were repurchased by their respective issuers at 90% of asset value, with the consent of the stockholders of the companies.[42]

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[38] Id., at 4529. In addition, Mr. Presley testified that Atlas Corporation could have acquired enough additional shares of common stock of National Investors Corporation to give it working control of that company, which in turn owned 100,000 shares of the common stock of Second National Investors Corporation, out of a total of 300,000 shares outstanding, and 20,000 shares of Third National Investors Corporation (ibid.).

[39] Id., at 4527–30.

[40] Id., at 4540.

[41] Ibid.

[42] Id., at 4532–7.

In 1936, Atlas Corporation sold its holdings of the stock of National Investors Corporation common stock to Hayden, Stone & Company, and the Adams Express Company, an investment company under the influence of Hayden, Stone & Company.[43]

2. ATTEMPTED ACQUISITION OF CONTROL OF OVERSEAS SECURITIES CO., INC., BY FISCAL MANAGEMENT GROUP

The refusal of the management of Overseas Securities Co., Inc., "to sell their stockholders down the river"[44] is also illustrative of the necessity for the support of the controlling interests in any acquisition of control of an investment company and the subsequent diversion of its assets to the purposes of the acquirers. In the latter part of 1937, Cleveland Storrs, a partner in the New York brokerage firm of Graham & Co., acting in the capacity of a "finder" of investment companies for the Fiscal Management group, approached Morton H. Fry, the president of Overseas Securities Co., Inc., to ascertain whether or not a controlling block of the company's stock could be purchased by Mr. Storrs' principals. The names of such principals were not disclosed to Mr. Fry, who, after consulting with directors and large stockholders of Overseas Securities Co., Inc., imposed three conditions precedent to further negotiations. Mr. Fry, in his testimony, described these conditions as follows:[45]

> We would have to know who the principal was. The second was that we would have to have assurance, assuming that they would be responsible, that their assurance could be trusted as to what they intended to do with the company. This [Overseas Securities Co., Inc.] was one of the first of the publicly owned trusts and it had a reasonably good record considering all the times and we felt responsible for it and there were some bonds outstanding there, I think somewhere around $1,110,000 of bonds at the time, and we said obviously we did not want to sell the bondholders down the river. Therefore, we wanted definite assurance from the ultimate buyer that if a transaction were consummated, the character of the trust would not be changed, that is, it would have a general portfolio just as good, and they would not put a block of other stocks in, or something of that kind; and the third condition was that the same offer would be made to all of the shareholders of record that was made for the purchase of the control stock, and that that offer be kept open for a sufficient length of time to be able to take advantage of it.
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> * * * * * * *
>
> Q. You say the three conditions you imposed were, first you wanted to know who the principal was; second, you wanted some definite assurance that the basic nature of the trust would not be changed; and, third, they had to make the same offer to the minority stockholders that they were making to the majority stockholders.
>
> A. That is correct.
>
> Q. What impelled you to impose those conditions, I mean did you mean that the officers and directors and sponsors of this trust owed it to the minority stockholders?

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[43] Id., at 4543.
[44] Op. cit. supra, note 1, at 447.
[45] Id., at 445–7.

A. My firm [Scholle Brothers, members of the New York Stock Exchange] and my associates and the directors were personal friends of mine, and we had been connected with this trust since the beginning. We felt a certain sense of trusteeship, and that it was an utterly unfair thing to sell the stockholders or bondholders down the river.

Because of these conditions imposed by Mr. Fry, precedent to the transfer of control of Overseas Securities Co., Inc., the group, represented by Mr. Storrs, terminated its negotiations with Mr. Fry.[46]

Other managements, however, were less concerned with their "trusteeship" to their stockholders. By purchasing the existing "control" of these managers, the acquiring individual or corporation could either secure their active cooperation or at least their passive acquiescence to its program. Frequently, existing sponsors and managers could be induced for a consideration to recommend actively the acceptance of exchange offers. Many of the agreements, consummated with the previous controlling interests for a shift in control, contained an undertaking upon the part of the transferors of control to refrain from making market purchases of the controlled company's securities except under the direction and for the account of the prospective purchaser of control. In this manner, the acquirer gained control of the market for the acquired company's securities.

C. Sources and Emoluments of Existing Management Control

An understanding of the methods by which control of investment companies was acquired requires a discussion of the devices by which control had been vested in the previous managements.

In the case of leverage investment companies, usually those in control held the common stock which originally had been acquired for a consideration far smaller than that contributed by the senior security holders. This common stock held by the sponsors had, from the point of view of asset value, become worthless due to the decline in value of the corporate assets to an amount insufficient to cover the liquidating value of outstanding senior securities. The decline in value of the corporate assets, in a number of cases, had been due to incompetent management, or self-dealing with the company's assets, as well as to unwise investment or speculation in common stocks indulged in by the management in an attempt to take advantage of the leverage imparted to their common stocks by the funds contributed by the senior security holders. One management even caused the investment company to operate a large margin account in some of its portfolio securities.[47] By this method of trading, the "leverage" in the common stock (large blocks of which were held by the management) created by the funds contributed to the enterprise by senior securities was supplemented by borrowed funds.

Following the collapse in 1929 of security prices, the senior securities of leverage companies were selling at discounts below their asset

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[46] Id., at 446. For the failure of the attempts of Atlas Corporation and of Tri-Continental Corporation, because of management opposition, to acquire control of Vick Financial Corporation, see Public Examination, Vick Financial Corporation, at 3584–5; and for the failure, for similar reasons, of the attempt by Phoenix Securities Corporation, an investment company controlled by Wallace Groves, to acquire control of Standard Investing Corporation, see Ch. II of this part of the report, pp. 613–14.

[47] See infra, p. 1097.

value. The common stocks, which represented control of the management of the company and usually also possessed the sole power to dissolve the company, had no asset value or negative asset values and were selling in the market at nominal prices which, of course, exceeded their asset value. In this situation, the acquiring corporation or individual purchased from those in control their common stocks with negative asset value at prices far in excess of their nominal market value.

Normally, the payment of such prices in excess of asset and market values is a reflection of the purchaser's opinion of the value of control of the assets of the company (assets which belonged entirely to the senior security holders of the company), or the value of the leverage of these common stocks. The willingness to pay such prices may be motivated by, and may be at least some indication to the sellers of, an intention upon the part of the purchaser to recoup the purchase price as well as to derive a profit directly or indirectly from the control of the funds. This recoupment or profit might conceivably be made at the expense of the senior security holders of the company.[48]

The purchaser of control may intend to profit by self-dealing with the acquired company [49] or by the acquisition of the remaining shares of the company's stock for a consideration less than the asset value of such stock, or the purchaser may intend to speculate excessively with the controlled company's assets in an effort to profit on his investment in its stock.

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[48] The same objectives on the part of the purchaser would also be suggested by the payment of prices in excess of actual value for controlling blocks of the stock of nonleverage companies, management contracts, warrants, and other instruments of control held by existing managements. In *Field* v. *Western Life Indemnity Co.*, 166 Fed. 607 (N. D. Ill. 1909) *aff'd sub. nom. Moulton* v. *Field*, 179 Fed. 673 (C. C. A. 7th, 1910), one Mr. Gray had a contract, which expired in four years, to manage a mutual life insurance company at a salary of $12,000 per year. This contract he sold for $125,000. The purchaser, apparently without the knowledge of Mr. Gray, then sold to the insurance company worthless assets to derive the funds necessary to pay Mr. Gray for his management contract. In its opinion the court said "An offer of $125,000 for what Gray had to sell was excessive to a degree which could not have failed to put Gray upon notice that some raid on the company's reserves was contemplated." The court accordingly held Mr. Gray liable for the damages suffered by the company as a result of the defalcation of the new manager.

Many of the sellers of controlling blocks of negative asset value common stocks of leverage investment companies testified that the substantial prices paid to them for such stock were based on the "leverage" value of the shares and therefore would arouse no suspicion as to the motives of the purchaser, particularly if such purchasers were of good reputation. See testimony of C. K. Reynolds, vice president of Reynolds Investing Company, Inc., control of which was sold to the Fiscal Management group by the Reynolds family (Public Examination, First Income Trading Corporation et al., at 1170–1) ; see also Ch. II of this part of the report, pp. 414–37, for activities of Fiscal Management group in acquisition of control of Reynolds Investing Company, Inc., and this chapter, supra, pp. 1072–5.)

Lansing McVickar, a professional "finder" of investment companies the control of which were for sale, testified that a controlling block of the common stock of a leverage investment company had not only a "leverage" value but also a "salary and management fee value" and a "brokerage commission value." By these latter "values" he meant that the purchaser had the power to award himself a salary or management fee for operating the company as well as the brokerage business of the company if he were a broker. Mr. McVickar also suggested that if he were not the broker a method could be devised whereby the purchaser of the controlling interest could share in the brokerage commission (op. cit. supra, note 1, at 908–9).

[49] See, for example, the tactics used by Wallace Groves and the Fiscal Management group to acquire control of investment companies, described briefly, supra, pp. 1031–9 ; 1072–5, and in more detail in Ch. II of this part of the report, pp. 181–226 and pp. 350–496.

Thus, Gerald Beal, the president of J. Henry Schroder Banking Corporation, which in October 1937 sold its controlling block of the negative asset value common stock of Continental Securities Corporation to the Fiscal Management group, with consequences to the senior security holders of the investment company which have already been described,[50] testified: [51]

Q. Well, isn't this a fact, Mr. Beal, and I won't pursue this any further, anybody who will pay you $20 a share for stock which had, when you started negotiations, a minus $11 value, and which had a greater minus value at the time the deal was actually closed, either would have one of several ideas to get his money back * * * when he gets control he can do one thing, that is put his hands on the cash. That is one way of getting his money back, that is the outrageous way, isn't it?

A. Yes.

Q. Or he may really be a high class man who thinks he can handle the portfolio better than anyone else—but you are not very much impressed with that type of individual, because I know that you know too much about the stock market to put any credence in that type of man——

A. Yes.

Floyd B. Odlum, the president of Atlas Corporation, discussing the necessity for acquiring in any expansion program the controlling common stock of leverage companies even though their acquisition would result in a loss asset-wise on such purchases, testified: [52]

A. At the time of the acquisition program, a great many of the leverage types of companies had lost assets until their common stocks were below any value, asset-wise, but they all had a market. In other words, the so-called low-price level common stocks were selling at a premium. The preferreds in the same company were selling at a substantial discount, and therefore in order to swallow that company, if I may use that term, in order to absorb it and get into the management, it would do no good to go out and buy the preferred and stay there because the common controlled the management and the portfolio and you could never do anything. We had to as an incident of the purchase, acquire these common stocks, and in many of them any money we paid for them we were losing asset value.

Q. That is precisely the point that I am making is that the money was to be made on the preferred and the common was just a means to an end and you were willing to pay above asset value for the common stocks not only for its leverage value but for its control value; isn't that so?

A. We were not only willing but we had to do it in order to do anything with that company.

Q. And that explains why you didn't make as much on the common as you did on the preferred; that was the price that you were paying to get control of other people's money; isn't that so?

A. Not at all. We weren't paying to get control of other people's money. We didn't want other people's money. We wanted to acquire these companies and make a profit on the difference between asset value——

Q. Listen to me carefully. I didn't say to take other people's money.

A. To get control.

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[50] See supra, pp. 1072–5.

[51] Op. cit. supra, note 1, at 507.

[52] Public Examination, Atlas Corporation, at 17831 and 17998.

Q. Yes. Except in those extraordinary cases where the preferred stock had the controlling vote on the passing of a dividend, the control of these various companies was lodged in the common stocks even though they had no asset value and were under water, isn't that so?

A. In the typical case; yes.

Q. So that you went out and bought those common stocks, even though they had no asset values and in many instances had a negative value, because the preferred would first have to come back before the common even had any asset value, as you expressed it, to get quickly to the management of the funds, isn't that so?

A. We couldn't move on the company at all, unless we acquired that common.

* * * * * * *

A. * * * Your common stock would be selling at a premium over asset line-up values and your preferred stock would be selling at a discount (from asset value) and we had to combine those assets in proportion from the standpoint of our cost in order to achieve our objective. * * * So we tried all the way through our program to regulate it that as we acquired preferred stock we would be acquiring these non-asset value common stocks in proportion.

E. F. Henderson, who, with his brother, G. B. Henderson, and A. L. Moore, acquired between 1934 and 1937 control of several investment companies largely by the use of the funds of the acquired companies themselves,[53] testified that it was a "fair assumption"[54] that the purchaser of a controlling block of negative asset value common stock of an investment company might be tempted to risk the corporate funds in extremely speculative transactions in an effort to enhance the value of his common stock. In 1934, Mr. Henderson and his associates purchased for $10,000 the common stock (stock with a negative asset value) of Beacon Participations, Inc., a company then having total assets of approximately $250,000 as compared with the liquidating preference of approximately $840,000 of the company's outstanding senior preferred stock.[55] The investment company's assets would thus have had to increase more than fourfold before the common stock would acquire any asset value. E. F. Henderson testified:[56]

Q. I am not making any light assumption when I say you were prepared to pay $10,000 for stock that had a minus value to the extent the assets would

[53] Public Examination, General Investment Corporation, at 15319 et seq.

[54] Id., at 15368–9.

[55] The capitalization of Beacon Participations, Inc., in June 1934 consisted of approximately 42,000 shares Class A participating preferred stock entitled to a preference in assets on liquidation of $20 per share; 25,000 shares of Class B participating preferred stock entitled to a preference after the Class A stock of $20 per share; and 25,000 shares of common stock. The Class A preferred stock had an asset value of $5.75, and the Class B preferred stock and the common stock had no asset value. (Reply to the Commission's questionnaire for Beacon Participations, Inc., Pt. IV; and Public Examination, General Investment Corporation, at 15318.) Mr. Henderson and his group purchased from the First National Bank of Boston all of the Class B preferred and all of the common stock for $10,000 (Public Examination, General Investment Corporation, at 15318–9).

[56] Op. cit. supra, note 53, at 15368–9. After the Henderson group acquired control of Beacon Participations, Inc., its assets, which had consisted of diversified securities, were utilized to purchase substantial blocks of the negative asset value common stock of other leverage investment companies having a speculative value because of their "leverage" (id., at 15323 et seq.) At December 31, 1938, more than one-half of the value of the assets of Beacon Participations, Inc., valued at market, consisted of holdings of the securities of other investment companies affiliated with the Henderson group (*Moody's Manual of Investments, Banks, etc.*, 1939, pp. 1896–7). Although as at June 30, 1937, the asset

have to come back fourfold before your interest would have any liquidating value.

A. That is right.

Q. Another thing I am curious about. It seems to me a fund of $250,000 with preferred three-quarters under water and where assets have to recover fourfold you would have to engage in some very very speculative transactions, or engage in some activity where the chances for profit would have to be extremely great. Isn't that so?

A. I think that is a fair assumption.

Q. So there is no doubt about the fact when you paid $10,000 to get a substantial interest, you were in a position where you could control the $250,000. The nature of your activities if you were to make money on the stock had to be such that you would have to manage the $250,000 in such manner as to make big profits if you ever hoped to see any assets behind the common stock. That is true, isn't it?

A. Yes, sir.

Nevertheless, although the substantial prices paid to retiring managements for their control should have served to warn them of possible future activities of the purchasers which might be detrimental to the interest of the stockholders, few of the selling management exacted any conditions to their sales which would operate to protect stockholders.[57] Rarely did they require the purchasers to adhere to the previous investment policies of the company,[58] or if such requirement was exacted no steps were taken to see that it was observed. Usually none of the previous officers and directors retained their positions in order to observe, for the benefit of stockholders, the operations and transactions of the new management.[59]

In the nonleverage investment companies, those in control may have maintained their domination either by the ownership of working or actual majority control of the stock. In this situation, the acquiring individual or corporation was required to purchase the stockholdings of those in control at prices at least equivalent to their asset value and substantially in excess of their market value.[60]

In the absence of a substantial stock interest in the company, managers of investment companies held control either because of the inertia of stockholders combined with a control of the proxy machinery or by means of long-term management contracts. To acquire control in these situations, the acquiring company purchased the management contracts at attractive prices.[61] These management contracts usually had been taken by the sponsors of investment companies prior to the public sale of the company's securities. They were solely the result of self-dealing upon the part of the sponsors. Usually the compensa-

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value of the Class A preferred stock, which was held primarily by the public, had increased from $5.75 in June 1934 to $29.22 as a result of the advantage of the "leverage" in its holdings of the stock of affiliated investment companies in a period of rising markets, on December 31, 1938, the asset value of the Class A preferred stock had declined to $13.53 per share (ibid.). The common stock of Beacon Participations, Inc., thus acquired no asset value during the period of the control of the company by Henderson Brothers.

[57] See, e. g. Ch. II of this part of the report, pp. 350–496, for a detailed account of the activities of the Fiscal Management group and the Northern Fiscal group.

[58] Ibid.

[59] Ibid.

[60] See infra, Sec. III.

[61] Ibid.

tion provided for in these contracts was an annual fixed percentage of the corporate assets, so that the managers were assured of revenue whether or not the company's operations were successful.

Investors purchasing the investment company's securities were induced to do so by representations of continued management of the investment company by the sponsor. In other words, the management contract was intended as personal and not capable of assignment without the consent of the stockholders.[62] Nevertheless, when these contracts became unprofitable or when the revenues accruing to the managers from them had substantially declined, these contracts were assigned to new interests without the prior knowledge or consent of the stockholders.[63]

Where those in control held neither stock nor management contracts, they usually held warrants ordinarily issued as permanent management compensation to the sponsors and managers of the company to purchase stock at prices far in excess of the market and asset value of the security purchasable under the warrants. In other words, the warrants were of no actual immediate value. The purchase of these warrants by the acquiring corporation served as an inducement to the managers of companies to recommend exchange offers of the acquirer's stock for the stock of their companies, thereby giving the acquirer an opportunity to accumulate a sufficient amount of stock to give it control of the company. In addition to purchasing the sponsor's warrants, commissions were sometimes paid to sponsors for their aid in consummating exchange offers.[64]

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[62] Ordinarily the performance of expert services to be rendered pursuant to the terms of a contract cannot be assigned to others without the consent of the person for whom the services are to be performed (2 Williston, contracts (1936), §§ 411 and 411A; *Moulton* v. *Field*, 179 Fed. 673 (C. C. A. 7th, 1910). However, in the case of management contracts, the investment company, as an independent legal entity, is the contracting party and not the stockholders. And the technique has been to receive the consent of the corporation, through its directors, to the assignment of the contract, a consent which normally is not difficult to obtain, since the holder of the management contract usually controls or has influence with the board of directors of the investment company. Compare the cases discussed infra, pp. 1178–1302. Nevertheless, the courts have held that the holder of a management contract with a corporation occupies a position of trust, and any funds he obtains from the sale of his contract must be paid into the corporate treasury. In *Moulton* v. *Field*, discussed in note 48, supra, one Mr. Gray held a contract for four years to manage a mutual life insurance company at a salary of $12,000 per annum. This contract Mr. Gray sold for $125,000, and thereby put the purchaser in control of the company. The directors of the company approved the sale of Mr. Gray's contract and entered into a new management contract with the purchaser. The purchaser thereafter sold to the company for $200,000 certain worthless assets and used the funds so obtained in part to pay Gray for his management contract. In holding Mr. Gray and others liable for the losses suffered by the insurance company, the court said:

> "If the succession was worth $125,000 in the market, the sale (if it were lawful) should have been made by the directors for the benefit of the owners of the business, not of Gray, for Gray had nothing legally assignable. His contract being for personal service was not assignable; and the resolutions of the directors really created a new contract with Rosenfeld (the purchaser). So the assignment * * * by which the offices of general manager * * * were sold to Rosenfeld and the consideration turned over to Gray, instead of into the treasury, was a betrayal of trust."

[63] On May 4, 1939, E. A. Pierce & Company, a large New York brokerage firm, announced its intention to sell to a company controlled by Roosevelt & Son its control of Fundamental Group Corporation, a company holding contracts both to manage and to distribute publicly the securities of Fundamental Investors, Inc., an open-end management investment company incorporated in 1932. However, it was also announced that the proposed sale was to be submitted to the stockholders of Fundamental Investors, Inc., for their consideration and approval prior to the consummation of the sale.

[64] See infra, pp. 1247–78.

Another means of acquiring control in addition to that provided by the purchase of stockholdings, warrants, and management contracts, was by the purchase of contracts for the distribution of securities. Managers holding the warrants, management contracts, or distribution contracts with the investment company, could be induced by their purchase to cause the investment company to sell substantial or controlling blocks of treasury or original issue stock of the company to the acquiring corporation for cash or other assets equivalent to or less than the asset value of the stocks issued.[65]

Finally, if none of the above avenues to control existed, control could be acquired by an exchange offer which was recommended by influential directors to whom secret commissions had been paid for their services.[66]

In addition to the attractive prices paid to sponsors and managers for their securities, warrants, or management contracts, former banker and broker sponsors and managers were sometimes assured of a continuance of the principal emolument of their former controlling position—brokerage commissions.[67]

It is obvious that the purchase at attractive prices of the stock interest of those in control, their warrants, their management contracts, and the continuance of their brokerage commissions, would be a strong inducement to these sponsors either to cooperate with or not to oppose the acquirer in its further stock purchases and in its exchange offers—programs of acquisition which might be profitable to the purchaser at the expense of stockholders to whom the former sponsors owed a duty of trust and protection. Further, the acquisition of all or nearly all of the stock of their investment companies by another company would substantially lessen the possibility of stockholders' suits against former sponsors and managers to account for losses caused by their mismanagement. Presumably, the acquiring corporation which was interested only in acquiring assets at less than their asset values would not be greatly tempted to investigate and compel restitution of losses incurred by the company because of mismanagement by those formerly in control.[68] Exchange offers

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[65] See infra, pp. 1258–78 and 1302–3.

[66] See infra, pp. 1324–45.

[67] See infra, pp. 1304–16.

[68] In *Glickenhaus* v. *Anderson* (Supreme Court of the State of New York, New York County, Special Term, Part I (Noonan, J.)—New York Law Journal, November 10, 1938, at 1562), an action by minority stockholders of The Equity Corporation against its present directors and officers (referred to in the complaint as the "Milton group") and the directors and officers of the predecessor companies of The Equity Corporation, the complaint alleged: That on December 7, 1932, The Equity Corporation acquired control of Interstate Equities Corporation, Chain & General Equities, Inc., and Yosemite Holding Corporation, and that these companies were subsequently merged with The Equity Corporation; that in May of 1933 the "Milton group" had purchased control of The Equity Corporation from Wallace Groves (see supra); that in November of 1936 the plaintiff had requested the Milton group to sue the former officers and directors of Interstate Equities Corporation, Chain & General Equities, Inc., and Yosemite Holding Corporation for alleged mismanagement of the affairs of these companies; that the Milton group had undertaken to investigate the acts and transactions of the prior management of these companies; that The Equity Corporation has commenced an action against Wallace Groves only to recover the profits made by Mr. Groves on the sale by him of 642,517 shares of the stock of Interstate Equities Corporation to Chain & General Equities, Inc.; that this was the "weakest possible action" that could have been brought despite the fact that all of the causes of action alleged in the instant complaint could and should have been included in The Equity Corporation action against Mr. Groves and despite the fact that the Milton group knew that each and every director

usually met with no opposition from the former managements after they had sold their controlling interest, whatever its nature, to the acquiring corporation. Many of the former sponsors, for a commission, solicited exchange offers of the stock of their companies for the stock of the acquirer and acted as brokers for the acquirer in the purchase of the shares of their companies. And as will be seen, in some cases the purchase of warrants held by sponsors was conditioned upon their recommendation of exchange offers. Infrequently were these transactions with their sponsors and managers disclosed to stockholders of acquired companies.[69]

In the following subsection these varied methods of acquisition will be illustrated by specific case histories. In each case a brief history of the acquired company prior to its acquisition will be given. The methods by which the prior management had acquired control, the passage of such control to new interests, the assistance given by the prior sponsors to the accomplishment of the acquirer's objectives and the use of the acquired company's funds to aid the objectives of the acquirer will also be described.

D. Inducing Management Support or Acquiescence

1. PURCHASE AT ATTRACTIVE PRICES OF "INSIDERS'" STOCK

The common method of acquiring control of a company is the purchase of the controlling blocks of stock held by the company's managers and other "insiders" at a price representing a substantial premium over the market value, in some cases over the asset value, and in some cases substantially in excess of the original cost of such securities. This technique, as has been described, was used by Wallace Groves and the Fiscal Management group.[70] It was also used by The Equity Corporation and by Atlas Corporation.[71] In nearly all these cases the price was substantially in excess of the consideration in cash or

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of The Equity Corporation and its predecessor corporations were necessarily as guilty of the acts complained of and as liable to The Equity Corporation for damages sustained by it as a result thereof as defendant Groves, and that the failure of the Milton group to sue the officers and directors of the predecessor corporations other than Mr. Groves was not based on the exercise of honest judgment but was made in bad faith because of the business and social relationships of the Milton group with these former officers and directors and a desire on the part of the Milton group to withhold action against such directors in order to permit the statute of limitations to run against possible suit against such former officers and directors. In denying a motion by The Equity Corporation for an order dismissing the complaint Justice Noonan stated:

> It seems to me that the plaintiffs have stated sufficient facts to establish a state of mind on the part of the present board of directors which was lacking in good faith and honest judgment. It must be remembered that the present attack on the amended complaint concerns a question of pleading only.

[69] Undisclosed agreements by those seeking control of a corporation, to compensate officers and directors and others in a fiduciary relationship to the stockholders for their aid in acquiring shares of the corporation by purchase or exchange offers, are illegal, even though the purchase price or exchange offer may be a fair one in the circumstances. A fiduciary may not place himself in a position where he may be tempted to favor his own undisclosed interest at the expense of those who have placed their trust in him. *Carlisle* v. *Smith*, 234 Fed. 759 (D. C. D. Ga. 1916); *Horbach* v. *Coyle*, 2 F. (2d) 702 (C. C. A. 8th 1924); *Kratzer* v. *Day*, 12 F. (2d) 724 (C. C. A. 9th 1926).

[70] See supra, Sec. III.

[71] Ibid.

stock subsequently paid by the acquiring individual or corporation to minority holders of the same class of securities in the course of a program to absorb eventually the assets of the acquired company. Thus "insiders" received preferential treatment in a program of acquisition which essentially constituted a reorganization of the rights and financial interests of the stockholders of the acquired company.[72] And where the "insiders" control stock was leverage common stock without asset values, the loss to the acquiring corporation represented by the purchase of the insiders' shares may have been a factor in the determination of the extent to which preferred stockholders who received exchange offers were to be deprived of their asset values. In other words, as has been pointed out, the loss on the purchase of the "insiders'" stock was, in the intention of the acquirers, to be recouped at the expense of senior security holders.

Mr. Odlum, the president of Atlas Corporation, testified that, in the case of his corporation, the premiums paid for "insiders'" securities were paid to acquire control.[73] In few cases, however, was the program of the acquirers in any manner opposed by "insiders" who had received premium values for their securities. In fact, in several

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[72] The courts have held that a management which sells its holdings to another corporation at a favorable price with knowledge that the acquiring corporation intends to obtain the remainder of the outstanding shares by purchase or exchange offers on less favorable terms, particularly where it aids the acquiring corporation in soliciting acceptance of such exchange offers without disclosing the preferential treatment which it has been accorded, is guilty of a breach of trust and must account to minority stockholders to the extent of the dollar amount of the preference it has received. *Dunnett* v. *Arn*, 71 F. (2d) 912 (C. C. A. 10th, 1934); *Sautter* v. *Fulmer*, 258 N. Y. 107, 179 N. E. 310 (1932); *McManus* v. *Durant*, 168 App. Dev. 643, 15, N. Y. Supp., p. 580 (1st Dept., 1915); Cf. *Westward* v. *Continental Can Co.*, 80 F. (2d) 495 (C. C. A. 5th, 1935). In the Dunnett case, supra, the defendants held a majority of stock of the Operators Oil Company. These shares they sold at an attractive price to Sunray Oil Company with knowledge that the latter intended to acquire all of the assets of Operators Oil Company by means of an exchange offer of its shares for the shares of Operators Oil Company held by minority stockholders. The defendants recommended Sunray Oil Company's exchange offer without disclosing the price they had received for their Operators Oil Company shares. The terms of the exchange offer were less favorable than those which had been received by the defendants. The court held the defendants liable to account to the minority stockholders. The Court said:

> Cloud and Dunnett (the defendants) arranged for a sale of the corporate stock of the Operators Company to the Sunray Company as a means whereby the Sunray Company would absorb the Operators Company and acquire its assets. The transaction, as we have stated, while in form a sale of stock, in substance and effect was a sale of the assets of Operators Company to the Sunray Company, and a corporate act; and it was the duty of Cloud and Dunnett, as officers of the Operators Company to arrange such sale so that all of the stockholders would be afforded the opportunity to share in the proceeds of such sale proportionately according to their stock holdings. * * * This they did not do.

Although the courts do grant a remedy in a proper case, the practicality to the average stockholder of judicial relief may be doubted.

The average investor usually does not have the financial resources to institute and carry to judgment a law suit, and he may not become aware of the preferential treatment accorded to directors. Certainly such preferential treatment will not usually be disclosed to the stockholders. Compare the cases described in the text infra.

By Section 16 (a) of the Securities Exchange Act of 1934, the beneficial owners of more than 10% of any class of the equity securities only of corporations registered on national securities exchanges, as well as the officers and directors of such companies, are required to report any change in the ownership of their holdings of such equity securities to this commission which publishes such facts. However, that section does not require the reporting of the price received for the transfer of such securities. See supra, Sec. I, note 27.

[73] Mr. Odlum testified (op. cit. supra, note 52, at 17777 and 17795):

> A. * * * I unequivocally deny that the payment of cash was made to anybody except in a case like I brought out in All America General, or that stock was bought above its asset value or that option warrants were bought, or that management con-

cases "insiders" at least passively aided the acquiring individual by agreeing not to compete with and by acting as its broker in the purchase of further securities of the acquired company. In other cases "insiders" actively solicited, for a commission, the acceptance of exchange offers.

a. Acquisition of Control of National Securities Investment Company by Atlas Corporation

(1) CAPITALIZATION AND SPONSOR CONTROL

National Securities Investment Company was incorporated in Delaware on June 18, 1926, with general power to invest in securities and to participate in the underwriting and syndication of securities.[74] The company was sponsored jointly by A. G. Becker & Co., Inc., and George Pick & Co., Inc., Chicago investment banking institutions. The directorate of the company throughout the period of the management of the company by its sponsors was composed predominantly of officers and employees of these firms.[75]

The original authorized capitalization of the company consisted of a 7% cumulative first preferred stock having a par and liquidating value of $100 per share, entitled to one vote per share, and redeemable by the corporation at $102 per share; a second preferred stock without voting rights, having a par value of $50 per share, a liqui-

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tracts were bought, or that brokerage business was given to induce anybody to—the language you used in your question—be actively helpful to us——

Q. Or passively acquiescent.

A. Or passively acquiescent. We did buy stock; we did buy option warrants; we did buy management contracts——

Q. You did promise brokerage.

A. Yes, but that is on a little different basis.

Q. That is Shields?

A. Others, too. We did buy stock; we did buy option warrants; and we did buy management contracts, not for the purpose of inducing anybody to get out and help us, but from the standpoint that we wanted to get the big blocks out of the way to enable us to go forward and get into control of the portfolio as quickly as possible and for that reason and for no other reason did we buy stocks, options, or management contracts.

Q. That analysis is all predicated upon one factor which may be present which, I believe, is not present, Mr. Odlum, and that is from your statement one would assume that you never bought option warrants from anybody unless he had a big block of stock that you wanted to acquire at the same time; that is not the fact, is it?

A. No, we bought option warrants where a person had nothing but option warrants.

Q. That is right. So in that situation, buying the option warrants, of course, would not give you a controlling block so that you could get quickly to the management of the portfolio and manage the portfolio?

A. If we hadn't bought the option warrants those would have been out against us and they were one of the most difficult situations in any company we went into.

Q. I am not unmindful of the fact of their nuisance value, but in the first instance, if you want to get control of a company you don't buy warrants which are exercisable at 25 when the asset value is 5.

A. You do if they are held by people who are managing the portfolio and you want to get in and manage it yourself.

Q. So that in those circumstances you are getting to the assets, the management of the assets, not by virtue of your ownership of a block of stock, but by virtue of the fact that you bought option warrants from an individual at a time when the asset value——

A. Yes, the purpose of buying the options on the stock was to get control of the portfolio, and not to influence these fellows to go out and make trades.

* * * * * * *

Q. And you say that the option warrants were never purchased with the intent of persuading the influential insiders to actively assist the Atlas Corporation in its exchange program?

A. I would say that the major reason and objectives in buying option warrants was to get the control and dominating influence out of the management and let us in. If it had the incidental effect of making them mentally hospitable with us, all well and good, and I certainly would not throw it down for that reason.

[74] Public Examination, National Securities Investment Company, Commission's Exhibit No. 1447.

[75] Id., at 14281.

dating value of $100 per share, and redeemable by the corporation at $102 per share; and a common stock of the par value of $5 per share and entitled to one vote per share.[76]

On June 29, 1926, the company sold privately 25,000 shares of its first preferred stock and 10,000 shares of its common stock. The shares were sold in units consisting of one share of first preferred stock and four-tenths of a share of common stock at a price of $100 per unit. No commitments in amounts less than $10,000 were accepted.[77] On the sale of these securities, National Securities Investment Company raised a total of $2,500,000.

On July 2, 1926, 10,000 shares of second preferred stock and 30,000 shares of common stock were purchased jointly by George Pick & Co., Inc., and A. G. Becker & Co., Inc., in units of one share of second preferred stock and three shares of common stock at a price of $100 per unit. By this sale, the company received $1,000,000.[78]

As a result of this private financing, the company had issued 25,000 shares of first preferred stock, 10,000 shares of second preferred stock, and 40,000 shares of common stock, and had received $3,500,000 in cash by the issuance of these securities. Of the 65,000 shares of voting stock outstanding (the first preferred stock had one vote per share), the sponsors, with an investment of $1,000,000, had obtained, by their holdings of 30,000 shares of common stock, approximately 44% of the voting power, while the stockholders not affiliated with the sponsors, who had invested $2,500,000 in the enterprise, had obtained 56% of the voting power. However, the holdings of the sponsors constituted the largest single block of voting securities and gave them effective control of the investment company.[79] In addition, the sponsors had so devised the capital structure of the company that three-quarters of all profits of the company would accrue to them after payment of the fixed dividends upon the senior securities.[80] In attempting to derive this large potential profit, the sponsors who had invested in the enterprise $1,000,000 had the "leverage," that is, the use for trading purposes of the $2,500,000 of public money invested in the enterprise.

From 1926 through 1928 the operations of the company were highly successful. As at December 31, 1928, the company's net assets at market were valued at approximately $11,331,721.33.[81] In January 1929, the sponsors determined to utilize their control to revise the corporation's capital structure in a manner which would operate to increase the possibilities of profits to themselves personally, insure to them control of the management of the corporation, and enable them to derive underwriting commissions from the sale of additional securities to the public. Accordingly, early in February of 1929, both the first preferred and second preferred stocks of the company were called for redemption on April 1, 1929, at a price of $102 per share for a total of $3,570,000.[82] On the redemption of their 10,000 shares of second preferred stock, A. G. Becker & Co., Inc., and George Pick

[76] Id., Commission's Exhibit No. 1447.
[77] Id., at 14274.
[78] Id., at 14276.
[79] Ibid.
[80] Id., Commission's Exhibit No. 1447.
[81] Id., Commission's Exhibit No. 1449.
[82] *Moody's Manual of Investments, Banks, etc.*, 1930, p. 2305.

& Co., Inc., not only received a return of their entire investment in the company, but derived a profit of $2 per share, or a total profit of $20,000.[83]

At this stage in the recapitalization plan, the company, after redemption of its senior securities, had net assets as of January 1, 1929, of $7,761,721.33 and had outstanding 40,000 shares of common stock, 10,000 of which were held by the public and 30,000 of which were held by A. G. Becker & Co., Inc., and George Pick & Co., Inc. As a further step in the recapitalization of the company, the 40,000 shares of common stock were exchanged for 600,000 shares of new common stock, of which the public held 150,000 shares and A. G. Becker & Co., Inc., and George Pick & Co., Inc., held 450,000 shares.[84] These shares, as has been indicated, had cost the sponsors nothing, since their investment of $1,000,000 had been returned to them upon the redemption of their preferred stock.

On January 31, 1929, A. G. Becker & Co., Inc. and George Pick & Co., Inc. agreed to purchase 250,000 shares of the company's common stock accompanied by "managers'" warrants to purchase an additional 250,000 shares of the company's common stock on or before January 1, 1939, at prices of $15 to $20 per share.[85] The total price paid by A. G. Becker & Co., Inc. and George Pick & Co., Inc. for this block of stock and warrants was $3,125,000,[86] the equivalent of $12.50 for each share of the 250,000 purchased. However, the market price of the common stock of the company at that time was between $25 and $28 per share,[87] so that at the date of purchase of the shares, the sponsors had a potential profit, based on the market price of the stock, of at least $3,125,000.

As a final step in the recapitalization of the corporation, additional capital was raised by a public sale of additional securities of the corporation. On January 31, 1929, the sponsors of the corporation agreed to purchase: (a) 200,000 shares of a new 6% cumulative preferred stock of the par value of $100 and entitled on liquidation of the company to a preference in the distribution of the assets of the corporation to the extent of $100 per share and accrued dividends and having one vote per share; and (b) 100,000 additional shares of the company's common stock and option warrants to purchase 100,000 shares of the company's common stock on or before January 1, 1934, at a price of $15 per share.[88] The total price to be paid by the sponsors for these securities was $20,100,000,[89] equivalent to a price of $100.50 for a unit of these securities consisting of one share of preferred stock, one-half share of common stock, and a warrant to purchase an additional half share of common stock.

Early in February 1929, A. G. Becker & Co., Inc. and George Pick & Co., Inc. offered to the public the above-mentioned securities in the form of allotment certificates covering a unit of one share of pre-

[83] In addition, the record indicates that on these shares A. G. Becker & Co., Inc., had received in dividends $78,512.50 (op. cit. supra, note 74, at 14285), and George Pick & Co., Inc., had received in dividends $86,367.50 (ibid.).

[84] Op cit. supra, note 74, at 14287.

[85] *Moody's Manual of Investments, Banks, etc.*, 1930, p. 2305.

[86] Op. cit. supra, note 74, Commission's Exhibit No. 1452.

[87] *Bank and Quotation Record,* December 1929.

[88] Op. cit. supra, note 74, Commission's Exhibit No. 1450.

[89] *Moody's Manual of Investments, Banks, etc.,* 1930, p. 2305.

ferred stock, one-half share of common stock, and a non-detachable option warrant to purchase one-half share of common stock. Each allotment certificate representing this unit of securities was sold to the public at a price of $103.50 per certificate.[90] After payment of expenses and the commissions of security dealers comprising the selling group formed by the sponsors to dispose of the securities, A. G. Becker & Co., Inc. received $276,366.09 and George Pick & Co., Inc. received $88,353.59 as net commissions.[91]

At the conclusion of the rearrangement of its capitalization and after giving effect to its additional financing, the company had received a total capital contribution of $23,225,000 which, when added to assets owned by the corporation after the redemption of its preferred stocks but prior to its recapitalization, gave it total net assets of $30,986,721.33.[92] The ownership of these assets was represented by 200,000 shares of preferred stock and 950,000 shares of common stock.[93]

The sponsors, as a result of the recapitalization and the additional financing, had acquired 700,000 shares of the common stock out of 950,000 shares outstanding, or 75% of the common stock. Their 700,000 shares of common stock constituted 60% of the outstanding 1,150,000 voting shares of the corporation (the 200,000 shares of preferred stock each had one vote per share). Thus, the readjustment of the corporation's capitalization had given the sponsor an actual majority voting control of the corporation. Prior to the recapitalization, as has been pointed out, the sponsors held only 44% of the voting stock.

The recapitalization had other advantages for A. G. Becker & Co., Inc., and George Pick & Co., Inc. As has been indicated, the total net investment which they had made in the company's securities was $3,125,000. Yet this investment gave them control of over $30,000,000 of assets, $20,100,000 of which had been contributed by the public in February 1929, and $7,000,000 of which represented the existing assets of the company after redemption of its old first and second preferred stocks but prior to the refinancing of the company. The sponsors had thus derived the "leverage" of $20,100,000 of the public's money with which they had the absolute power to speculate in the hope of enhancing their investment of $3,125,000 in the common stock of the corporation. Mr. Lester Roth of A. G. Becker & Co., Inc., conceded that the situation was not dissimilar to a margin account being operated for the benefit of the sponsor common stockholders with funds supplied by the senior security holders.[94]

The sponsors apparently took full advantage of their power to speculate with the funds of the public. The corporation's trading in portfolio securities was done largely through margin accounts. In addition to the funds invested by the public in the enterprise, additional leverage to the common stock was supplied by money borrowed by the company from banks and from brokers.[95]

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[90] Ibid.

[91] Op. cit. supra, note 74, at 14292.

[92] Id., Commission's Exhibit No. 1449.

[93] *Moody's Manual of Investments, Banks, etc.,* 1930, p. 2305.

[94] Op. cit. supra, note 74, at 14408, 14416.

[95] Thus, in 1929, a peak amount of $6,000,000 was borrowed by National Securities Investment Company to be used in speculative trading in securities (id., at 14334, and Commis-

(2) JOINT TRADING ACCOUNTS WITH SIDNEY Z. MITCHELL AND NATHAN L. AMSTER

The investment company also participated to a substantial extent in joint trading accounts with individuals who, according to the sponsors, possessed "inside dope" [96] on certain securities. These individuals, according to the managers of National Securities Investment Company, in consideration of the use of their "inside information," were advanced funds by the investment company at rates of interest substantially less than the prevailing rates on call loans obtainable from brokers. The interest of the investment company in at least one of these accounts was acquired by the investment company directly from its sponsors.

Prior to February 18, 1929, A. G. Becker & Co., Inc., George Pick & Co., Inc., and Sidney Z. Mitchell, the chairman of the board of directors of the Electric Bond and Share Company, had been operating a trading account primarily in the securities of Electric Bond and Share Company and its subsidiaries.[97] Each of the participants had a one-third interest in the account.[98] Mr. Mitchell had advanced no funds to be used by the account in its operations,[99] his share of the fund having been advanced entirely by A. G. Becker & Co., Inc., and George Pick & Co., Inc. On February 18, 1929, A. G. Becker & Co., Inc., and George Pick & Co., Inc., assigned their entire interest in the account to National Securities Investment Company.[100] The company reimbursed its sponsors not only for their interest in the account but also for their advances to the account on behalf of Mr. Mitchell.[101] The entire account, then composed of securities having a market value of $5,794,405.21, was taken over by the company at its market value.[102] On this transaction, A. G. Becker & Co., Inc., and George Pick & Co., Inc., each derived a profit of $1,110,536.20,[103] representing the difference between the cost of their proportionate interest in the account and the price paid by National Securities Investment Company for their interest in the account. The investment company had acquired a two-thirds interest in the account, and Mr. Mitchell retained a one-third interest in the account. On July 3, 1929, Mr. Mitchell agreed to take a one-half interest in the account in consideration of the receipt of one-half of the profits of the account.[104] The entire account was financed by the investment company. According to the sponsors, Mr. Mitchell, in anticipation of his "inside information" about the securities of companies in the Electric Bond and Share system of which he was chairman of the board of directors, was

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sion's Exhibit No. 1455). In addition the corporation's trading in securities was done largely through margin accounts, principally in the brokerage offices of Ladenburgh-Thalmann & Company (id., at 14416–19). As at December 31, 1928, the company owed to Ladenburgh-Thalmann & Company a total of $1,039,262 (id., at 14419). As at February 28, 1930, the company owed to Ladenburgh-Thalmann & Company alone $3,394,697.72 as a debit balance on a margin account maintained with that brokerage house (id., at 14418).

[96] Id., at 14308.

[97] Id., at 14307.

[98] Id., at 14313.

[99] Id., at 14319.

[100] Id., at 14313.

[101] Id., at 14319.

[102] Id., at 14314.

[103] Ibid.

[104] Id., at 14325 and Commission's Exhibit No. 1459.

charged a rate of interest on his debit balances substantially less than the current call loan rates.[105]

Approximately $13,000,000,[106] or 43% of the total of $30,000,000 in assets owned by National Securities Investment Company after its recapitalization in February of 1929, were invested in securities purchased in the operation of this account. Of this amount, the company itself had expended $6,199,684.09 for its own account and had advanced a like amount to Mr. Mitchell secured only by his proportionate share of the securities in the account.[107] On the termination of the account, Mr. Mitchell paid the balance due for his proportion of the account and received the securities in the account to which he was entitled.[108] National Securities Investment Company took down, as its share of the account, securities having a market value of $2,386,419.66[109] which had cost the company $6,199,684.09. Thus the result of this trading account, supposedly operated on the basis of "inside information," resulted in a loss to National Securities Investment Company of $3,813,264.43.

A similar trading account, in the common stock of the Chicago, Milwaukee & St. Paul Railway Company, was operated by National Securities Investment Company jointly with Nathan L. Amster who, according to the sponsors, was an authority on railroad securities.[110] As a result of this trading account on the basis of "inside information," the company eventually suffered a loss of $423,578.62.[111]

(3) SPONSORS' TRADING ACCOUNT IN SECURITY ISSUES OF THE INVESTMENT COMPANY

From February 9, 1929, to September 25, 1931, when Atlas Corporation acquired control of National Securities Investment Company, A. G. Becker & Co., Inc. and George Pick & Co. Inc., operated a trading account in the security issues of National Securities Investment Company.[112] Mr. Schaffner, the chairman of the board of directors of A. G. Becker & Co., Inc., characterized the purposes of this account as twofold: (a) to stabilize and maintain a market for the securities, and (b) to make money.[113] Mr. Schaffner testified that the sponsors as managers of National Securities Investment Company and as the underwriters of its securities conceived that they owed a duty to its security holders to provide them with a market for their securities—"to see that the stockholders could get an adequate market and not be compelled to sell the securities at terrific

[105] Id., at 14327. Mr. Mitchell paid 4% interest, whereas interest rates on brokers' loans during 1929 averaged 10.44% (ibid.). In order to finance Mr. Mitchell's portion of the account, National Securities Investment Company was compelled during 1929 to borrow from banks $6,000,000 (id., at 14334) at 6% interest. This sum was in effect loaned to Mr. Mitchell at 4% interest or at actual loss to National Securities Investment Company of $120,000 a year (ibid.).

[106] Id., at 14332.

[107] Id., at 14328.

[108] Ibid.

[109] Ibid.

[110] Id., at 14403.

[111] Id., at 14404. National Securities Investment Company invested a total of $461,396.87 in this venture. The stock which it purchased was ultimately sold for $38,018.25 (ibid.).

[112] Id., at 14341–3 and Commission's Exhibit No. 1460.

[113] Id., at 14343.

discounts (from asset value) and sustain uncalled for losses.[114] As Mr. Schaffner expressed it, "unless somebody is interested in the market, especially in inactive stock, there is no market for it." [115]

The trading account in the securities of the investment company, operated by its sponsors, was highly profitable. The profit to George Pick & Co., Inc., on its interest in the account was $523,811.16.[116] A. G. Becker & Co., Inc., as its share of the profits of the account, received $579,183.67.[117] On the transfer of control of the company to Atlas Corporation, the sponsors' trading account in the securities of the company was terminated for reasons which will be discussed later.

(4) TRANSFER OF CONTROL TO ATLAS CORPORATION

On March 31, 1931, George Pick & Co., Inc., sold 364,192 shares of National Securities Investment Company common stock and 125,000 option warrants to A. G. Becker & Co., Inc., at a price of 87½ cents per share for the stock or a total price of $320,488.96.[118] The sale disposed of George Pick & Co., Inc.'s entire security interest in the company. After the sale, the representatives of George Pick & Co., Inc., on the directorate of National Securities Investment Company resigned.[119] Thereafter, the company was managed by A. G. Becker & Co., Inc., exclusively. All of the directors and officers of the investment company were officers, directors, or employees of A. G. Becker & Co., Inc.

The purchase of the holdings of George Pick & Co., Inc., increased the shares of common stock of National Securities Investment Company held by A. G. Becker & Co., Inc., to 641,658½, which had cost A. G. Becker & Co., Inc., a total of approximately $1,900,000.[120]

By July 1931 National Securities Investment Company had sustained substantial losses, and A. G. Becker & Co., Inc., was convinced that it was desirable to sever its connection with the management of the company.[121] As at September 25, 1931, when Atlas Corporation purchased control of the company from A. G. Becker & Co., Inc., the net assets of National Securities Investment Company totaled $11,243,-309.36,[122] as compared with a net capital contributed to the enterprise by its stockholders of $17,600,738.75,[123] after treating as returns of capital $1,281,379.50 paid by the company in dividends after its recapitalization in February 1929 and $4,343,364.75 expended by the company in the repurchase of shares of its preferred and common stock.[124] Under the management of its sponsors, $6,357,429.39, or 36% of the net capital contributed to the corporation, had been lost [125]

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[114] Id., at 14351.

[115] Id., at 14344.

[116] Id., Commission's Exhibit No. 1470.

[117] Ibid.

[118] Id., at 14354, 14357.

[119] Derived from supplementary information supplied the Commission for National Securities Investment Company.

[120] Op. cit. supra, note 74, at 14359.

[121] Id., at 14364.

[122] Id., Commission's Exhibit No. 1456 and op. cit. supra, note 52, Commission's Exhibit No. 2043.

[123] Op. cit. supra, note 74, Commission's Exhibit No. 1456.

[124] Op. cit. supra, note 52, Commission's Exhibit No. 2003.

[125] Op. cit. supra, note 74, Commission's Exhibit No. 1456.

largely in speculative investment activities such as the joint trading accounts with Sidney Z. Mitchell and with Nathan L. Amster.

As at September 25, 1931, the date that control of National Securities Investment Company passed to Atlas Corporation, the company had outstanding 138,957 shares of preferred stock and 939,144½ shares of common stock.[126] Of the common stock, 641,658½ shares, or 68% of the total common shares outstanding, were owned by A. G. Becker & Co., Inc. A. G. Becker & Co., Inc.'s, holdings of common stock represented also approximately 59% of the total outstanding voting shares (preferred and common) of the company. However, A. G. Becker & Co., Inc., held little or no preferred stock of National Securities Investment Company.[127] The 138,957 shares of preferred stock of the investment company held by the public had a first claim on the assets of the company in the event of its dissolution, to the extent of $100 per share, or a total claim of $13,895,700. Since the investment company had net assets as at September 25, 1931, of $11,243,309.36, had the corporation been dissolved at that time, the preferred stockholders would have been entitled to all of the assets and would have received $73.72 per share on their stock.[128] The common stock would have been entitled to no part of the corporation's assets.

However, the preferred stockholders, although having voting rights, would have been unable to effect a dissolution of the corporation without the consent of A. G. Becker & Co., Inc., since the Delaware Corporation Law requires the consent of the holders of two-thirds of all classes of the voting stock of a corporation to effect a dissolution of the corporation.[129] A. G. Becker & Co., Inc., was, therefore, in a position to block a dissolution of the corporation although all of the assets of the corporation "belonged" in theory to the public holders of the preferred stock. The preferred stockholders also were powerless to prevent a shift in the control of their funds by A. G. Becker & Co., Inc.

Lester Roth, a director of National Securities Investment Company and an officer of A. G. Becker & Co., Inc., when examined on the realization of the preferences to which preferred stockholders may be entitled on liquidation, testified:[130]

Q. What protection is there to the preferred stockholder? He puts in the senior money on the assumption that he is willing to cut down his prospective profit and limit it to a fixed amount because he is assured some safety, isn't that so? Take your own case, when the time came when the preferred aspect should have been his protection and would have given him back his money, it was never given to him, isn't that so? And hasn't that been the history of investment trusts, that the aspect of protection which is supposed to be inherent in preferred stock, somehow or other never goes to the benefit of the preferred stockholder because the common stockholder is there and says you cannot liquidate the trust, isn't that true?

A. Well, perhaps * * *.

* * * * * * *

Q. Of course, applying to your own particular case, when the ultimate set-up was established the management put in $3,000,000 besides their $5,000,000 profit.

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[126] Id., Commission's Exhibit No. 1462.
[127] Id., at 14366.
[128] Id., Commission's Exhibit No. 1466.
[129] Del. Rev. Code (1915), Ch. 65, Sec. 39.
[130] Op. cit. supra, note 74, at 14410, 14412.

But as I visualize it, the motivating force for a person investing in preferred stock is the element of safety; isn't that so? He says, "If this trust goes wrong and there is any money left, I am going to get mine and, therefore, I am willing to take less profits than the person who has the common stock and is willing to gamble"; isn't that so?

A. Yes.

Q. And yet what situation arises? First, when the trust reaches a point where everybody is convinced that there either ought to be a substantial shake-up in the management or it is time to liquidate the trust, the preferred stockholder is not in a position to insist upon the dissolution because the common stockholder whose stock is worth nothing in asset value says, "I will not let you liquidate this trust." That is what A. G. Becker & Co., Inc. could have said with its common stock; isn't that so?

Mr. Schaffner. That is the contract the preferred stockholder makes.

Q. That is all right. I am just discussing whether we should permit such contract wherein individuals can say, "My stock is worth minus $20 and your stock is $72.72, but you cannot get your money. I am going to turn you over to Atlas Corporation." You certainly would say that there ought to be some moderate relationship between the amount of senior money and the amount of the equity?

A. Yes.

A dissolution of the investment company would have given all the assets to the preferred stockholders and involved a loss of the approximately $1,900,000 which A. G. Becker & Co., Inc., had invested in its holdings of 641,658½ shares of the common stock of National Securities Investment Company.

Early in September 1931 Robert C. Schaffner, of A. G. Becker & Co., Inc., approached Floyd B. Odlum (with whom Mr. Schaffner was personally acquainted), the president of Atlas Corporation, with a proposal to sell A. G. Becker & Co., Inc.'s holdings of the common stock of National Securities Investment Company to Atlas Corporation.[131] As has been pointed out, this common stock had no asset value, although it had a quoted market value of $3 a share at the time of the original negotiation between Atlas Corporation and A. G. Becker & Co., Inc.[132] The market price, however, was apparently the result solely of the trading account (which has already been described) then being operated by A. G. Becker & Co., Inc. in the stock of National Securities Investment Company. Some appraisal of the actual value of the common stock of the company may be gleaned from the fact that A. G. Becker & Co., Inc. paid George Pick & Co., Inc., 87½ cents per share for the latter's holdings of National Securities Investment Company's common stock at a time when its artificially created market value was approximately $6 per share.[133]

Since the common stockholdings of A. G. Becker & Co., Inc., in National Securities Investment Company had no asset value, its purchase would, to the extent of the purchase price, constitute a loss in assets to Atlas Corporation. However, if the preferred stock

[131] Id., at 14364.

[132] *Bank and Quotation Record*, September 1931.

[133] Op. cit. supra, note 74, at 14363. Mr. Schaffner conceded in his testimony that a sale of A. G. Becker & Co., Inc.'s holding of the common stock of the company on the open market would bring substantially less than $3 per share (ibid.).

of National Securities Investment Company could be acquired by Atlas Corporation for a consideration less than its total asset value, the gains so derived might be sufficient to offset the loss suffered by Atlas Corporation in the purchase of the common stock. Further, the common stock would put Atlas Corporation in control of the portfolio of National Securities Investment Company and would also enable Atlas Corporation to dissolve the corporation and thus realize its gains on its purchase of the company's preferred stock at prices less than its asset value. In sum, to Atlas Corporation the common stock of National Securities Investment Company was valuable only if it could acquire the preferred stock of National Securities Investment Company at less than its asset value.

On September 28, 1931, A. G. Becker & Co., Inc. and Atlas Corporation entered into an agreement [134] which provided that Atlas Corporation would "loan" to A. G. Becker & Co., Inc. $1,000,000 which was to be secured by the deposit with Atlas Corporation of 400,000 shares of the common stock of National Securities Investment Company owned by A. G. Becker & Co., Inc. A. G. Becker & Co., Inc. was not to be personally liable upon the "loan," but Atlas Corporation's sole recourse for payment of the "loan" was to be 333,333⅓ shares of the 400,000 shares of National Securities Investment Company stock deposited as collateral. In effect, the "loan" was a purchase by Atlas Corporation of 333,333⅓ shares of common stock at a price of $3 per share. Atlas Corporation also acquired an option to purchase at the price of $3 per share within 20 years the 66,666⅔ shares (the remainder of the 400,000 shares which constituted the collateral for the loan) and the 241,658½ shares of National Securities Investment Company common stock which constituted the remainder of the total holdings of common stock (641,658½ shares) owned by A. G. Becker & Co. Inc.

Atlas Corporation, however, was required to apply to the exercise of its option on the common stock the difference between the cost of each share of National Securities Investment Company preferred stock to be purchased by Atlas Corporation from the public, and 85% of the liquidating value of each share of such preferred stock at the date of its purchase. As preferred stock was purchased by Atlas Corporation from the public, the Atlas Corporation was to apply this differential between asset value and cost of the preferred stock, first, to the purchase of the 241,658½ shares of common stock of National Securities Investment Company not included in the collateral for the million dollar "loan," then to the purchase of the 66,666⅔ shares which constituted the excess of the collateral, and finally to the payment of the million dollar "loan," that is, to the purchase of the 333,333⅓ shares of common stock held as "collateral."

The agreement also provided that on making the "loan" Atlas Corporation was to have the immediate right to vote 333,400 shares

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[134] Id., Commission's Exhibit No. 1462. On October 2, 1931, the obligations of Atlas Corporation under this agreement were transferred to Chatham Phenix Allied Corporation, an investment company the control of which had been acquired by Atlas Corporation in August 1931. Chatham Phenix Allied Corporation actually advanced the $1,000,000 "loan" to A. G. Becker & Co., Inc., and received the common stock of National Securities Investment Company as collateral for the loan. See infra, pp. 1115–6.

of the 400,000 held as collateral for the one million dollar "loan." A. G. Becker & Co., Inc. also agreed to vote the common shares upon which it had given Atlas Corporation an option to purchase, in favor of Atlas Corporation's nominees for the directorate of National Securities Investment Company. A. G. Becker & Co., Inc. was to cause the officers and the board of directors of National Securities Investment Company to resign and was to turn over the management of the company to Atlas Corporation. The 250,000 option warrants of National Securities Investment Company owned by A. G. Becker & Co., Inc. were to be delivered to Atlas Corporation gratis.

In essence, the agreement provided that A. G. Becker & Co., Inc.'s holdings of common stock would be purchased by Atlas Corporation concurrently with purchases of preferred stock by Atlas Corporation from the public; and that payment for the common stock acquired from A. G. Becker & Co., Inc., would be made out of the asset gains to Atlas Corporation on purchases of preferred stock from the public, after reserving to Atlas Corporation an assured profit of 15% of the difference between the asset and market value of the preferred stock purchased. Stated otherwise, A. G. Becker & Co., Inc., would be paid for its common stock out of the asset losses suffered by the public preferred stockholders to whom A. G. Becker & Co., Inc., as the original underwriter and distributor, had originally sold the shares, and to whom A. G. Becker & Co., Inc., owed a fiduciary duty as the manager of their investment company. Mr. Odlum, in his testimony before this Commission, conceded that the substance of the agreement was that the asset loss suffered by Atlas Corporation on its purchase of the common stock of National Securities Investment Company was to be offset by the asset value gains to Atlas Corporation on its purchases of preferred stock of National Securities Investment Company:[135]

A. It was a loan that was kept in the form of a loan rather than a purchase.

Q. Why was that?

A. It was done for the reason, as I pointed out yesterday, when you talked about a leverage type company if it was "under water." It was a low price leverage non-asset value stock, and your common stock would be selling at a premium over asset values and your preferred stock would be selling at a discount (from asset value) and we had to combine those units in proportion from the standpoint of our cost in arriving at the objective. If we had bought the 600,000 shares of stock at $3 the net result eventually would have been the same. But in the meantime we would have paid out $1,900,000 which would have been completely thrown out of the window from our standpoint. So we tried all the way through our program to regulate it that as we acquired preferred stock we would be acquiring these non-asset value common stocks in proportion. * * *

Q. At any rate, that is the form it took?

A. Yes.

Q. It was really a purchase of 333,333⅓ shares at $3 a share?

A. That is correct.

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[135] Op. cit. supra, note 52, at 17998–18000.

Q. So that ultimately and essentially, Mr. Odlum, the Atlas Corporation was buying A. G. Becker's common stock with the money that it was making by buying the preferred stocks at this discount? Isn't that so?

A. Yes. That is essentially what we did in every case.

Q. And ultimately the entire block of stock which cost an aggregate of $1,900,000 was paid for by Atlas Corporation, in just that way?

A. That is correct.

Q. So that we have the situation here where Atlas Corporation purchased those 641,000 shares of common stock, which gave you control of National Securities Investment Company and did it over a period of time, using the money that was made on preferred stock; isn't that so?

A. Yes. And essentially you can say that irrespective of the mechanics, Mr. Schenker, that is typical of all companies where they had out preferred stock selling below asset value and the common selling above.

The investment company's preferred stockholders (to whom in principle all of its assets "belonged") and the minority common stockholders were not informed of or consulted with reference to the shift in control of their assets to Atlas Corporation prior to the transfer of control, although after the event these security holders were informed of the fact that their assets had come under the administration of a new management.[136] The details of the agreement of A. G. Becker & Co., Inc., with Atlas Corporation were, however, never revealed to the stockholders. The preferred stockholders were thus not given any choice in the selection of the new manager of their own funds, nor were they informed of the investment policy which their new manager intended to pursue. In fact, Mr. Schaffner testified that he did not know what the nature of the Atlas Corporation's policy in the investment of the funds of National Securities Investment Company would be:[137]

Q. So that A. G. Becker made up its mind that it was going to transfer control of this investment trust to the Atlas group; isn't that so?

A. Yes; that is true.

Q. And that wasn't submitted first to the stockholders to see if they wanted to go over to Atlas?

A. No.

Q. The stockholders, when they purchased this stock, paid their money in reliance on the integrity, ability, background, training, and all other virtues of A. G. Becker and George Pick; isn't that so?

A. That is true.

Q. And these stockholders had stayed with this trust through its ups and downs at the time when there was this $7,000,000 deficit; isn't that so?

A. A good many of them * * *.

Q. And at the time that A. G. Becker made the arrangement to sell control of this investment trust to Atlas Corporation, A. G. Becker & Co. had no substantial preferred position, did it?

A. No, sir.

Q. Had no preferred position?

A. I wouldn't say that without referring to the records.

Q. A negligible position?

A. That is right.

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[136] Op. cit. supra, note 74, Commission's Exhibit No. 1466.
[137] Id., at 14365–8.

Q. Its position was in the common stock, which had no asset value?

A. That is right.

Q. And the fact is that every dollar in that investment trust at that time—and there was approximately $11,000,000—belonged to the public and not to A. G. Becker & Co.; isn't that so?

A. That is true.

Q. And yet the control of the fund and the entire management and the entire direction and future investment policy and future conduct of this investment trust was turned over in quick order to Mr. Odlum and the Atlas Corporation, without even apprising the stockholders before it was done; isn't that so?

A. That is correct.

Q. That is a step of quite some consequence, was it not, Mr. Schaffner, looking back in retrospect, the turning over of other people's money for management to somebody, isn't it?

A. Yes; we didn't do it without a great deal of deliberation, as far as that is concerned.

* * * * * * *

Q. And you were saying to Mr. Floyd Odlum that "I think you ought to take these funds and manage it"; isn't that so?

A. Yes.

Q. Although literally it wasn't A. G. Becker's money, because if the trust was to be liquidated on that date A. G. Becker wouldn't get a nickel; isn't that so?

A. That is true.

With respect to the steps taken by the sponsors to ascertain the investment policy of the new management, Mr. Schaffner testified: [138]

Q. Of course, you had no assurance, Mr. Schaffner, as to what the future policy of the Atlas Corporation was going to be with respect to the investment of the funds, which were being turned over to them, isn't that so?

A. Why we had no definite, concrete assurance as to just what they were going to invest in; no, sir.

Q. So that under the broad power of the charter, Mr. Odlum, and the Atlas Corporation could invest it in any situation they saw fit, isn't that so?

A. Yes, sir.

* * * * * * *

Q. Now, I think you can also visualize a situation that a person might be willing to entrust his money to A. G. Becker & Company for management relying on their background and history and yet not be willing to have the Atlas Corporation manage its funds, isn't that so?

A. Well, that is all point of view, that wasn't our point of view at the time.

Q. That is not an unreasonable situation, you can visualize that?

A. Yes.

Furthermore, the agreement patently offered an inducement to A. G. Becker & Co., Inc., to acquire as cheaply and quickly as possible for the account of Atlas Corporation the preferred stock of National Securities Investment Company which that investment banking firm had sponsored. Essentially, A. G. Becker & Co., Inc., was to be paid for its holdings of common shares out of the asset losses suffered by preferred stockholders. Under the agreement, A. G. Becker & Co., Inc., was to be paid first on the 308,325$\frac{1}{6}$ shares of the common stock which were not "collateral" to the $1,000,000 "loan" but which were optioned to Atlas Corporation. As a consequence, it was to the pecu-

[138] Id., at 14370.

niary interest of A. G. Becker & Co., Inc., if it wished to sell the common stock upon which it had granted Atlas Corporation an option, to acquire as rapidly as possible the preferred stock of National Securities Investment Company for the account of Atlas Corporation.

When examined on the question as to whether the effect of the agreement was to induce A. G. Becker & Co., Inc., to acquire the preferred stock of National Securities Investment Company for Atlas Corporation's account as rapidly as possible, Mr. Odlum testified: [139]

Q. The agreement of September 28th was so drawn, was it not, that these discounts were first made applicable to the 241,658½ shares, which was the remaining block?

A. That is right.

Q. And then was made applicable to the 66,666⅔ shares of the remaining block; and then that same arrangement could be made applicable to that stock which was collateral for the note? Isn't that so?

A. That is correct.

Q. So there was an inducement, was there not, for A. G. Becker to pick up as much preferred stock as possible, because then not only would they be sure they would sell you the 333,333 shares that you would have to take down if they did not pay the note, but they would be sure that they sold you the 66,666⅔ shares [the remainder of the block collateralizing the "loan"] and also the additional 241,658½ shares of the common stock covered by the option; isn't that so?

A. From the cash standpoint of A. G. Becker & Company, there was certainly an inducement for them initially to acquire stock because they had already gotten the cash in the original block that was treated as a loan, and if they wanted more cash they could only get it by getting the stock in for us.

Q. And not only was it to their interest to get as much stock as possible, and not only was it to their interest to get it as quickly as possible, but it was also to their interest to get it as cheaply as possible.

A. From the cash standpoint; yes.

* * * * * * *

A. I said from a cash standpoint. He [A. G. Becker & Co., Inc.] sold more and more shares [of the common stock of National Securities Investment Company owned by A. G. Becker & Co., Inc.] faster than he otherwise would have sold them.

Q. Oh, no, Mr. Odlum, for this reason: so far as the balance of the stock was concerned and the balance, 308,325⅙ shares, you people [Atlas Corporation] only had an option and you were under no obligation to buy a single share.

A. But we had to apply the difference between the cost and 85 percent [of the asset value of the preferred stock of National Securities Investment Company purchased by Atlas Corporation]. The urge there was not the price but the urge would be to get as much preferred stock as we could get as quickly as possible, which would tend to put up the price, if anything.

Robert C. Schaffner, the chairman of the board of directors of A. G. Becker & Co., Inc., and the president of National Securities Investment Company, conceded that the agreement created in A. G. Becker & Co., Inc., a pecuniary interest to purchase the preferred stock of National Securities Investment Company from the public

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[139] Op. cit. supra, note 52, at 18002–3, 18006–7.

as quickly as possible, and admitted that A. G. Becker & Co., Inc., could effect the sale of 308,325 shares of its common stockholdings in the investment company only at the expense of preferred stockholders who sold their stock to A. G. Becker & Co., Inc., for the account of Atlas Corporation at prices substantially less than the asset value of their shares. Mr. Schaffner testified:[140]

Q. Now this balance of stock upon which the Atlas Corporation had the option at $3 per share, Atlas Corporation * * * provided * * * that with respect to these shares of stock, they could pay for that stock in this manner, that A. G. Becker & Co. would * * * get the difference between 85% of the asset value of the stock and the market value at which they bought it for Atlas account in the open market, isn't that so?

A. Atlas was to apply that much money on the exercise of the options.

Q. So that Atlas Corporation was under no obligation to purchase the balance of the common stock from A. G. Becker & Co., Inc. It only had an option?

A. It was under obligation to buy it as they bought the preferred.

Q. Aside from this preferred, the only obligation that Atlas Corporation had was to keep 333,333 shares for $1,000,000, isn't that so?

A. That and the obligation, you have just read.

Q. And then you said that you gave Atlas Corporation an option to buy the balance of the stock that you had at $3 a share.

A. Yes.

Q. Now, if Atlas Corporation didn't want to buy the balance of the stock at $3 a share or said "Stop buying the preferred" they were under no obligation to buy that block, isn't that so?

A. That is correct.

Q. So that the only way that A. G. Becker & Co., Inc., could be sure that they sold the balance of the stock at $3 a share was to go out and buy the preferred for the Atlas Corporation, isn't that so?

A. Yes.

Q. And the only way that A. G. Becker & Co., Inc., would be paid would be by buying the stock in the open market, as cheaply as possible, so that there would be a substantial difference between the asset value and the market value, isn't that so?

A. The only way A. G. Becker could buy it would be whatever the market price was.

Q. But I mean it would be to their pecuniary interest to buy the stock in the market as cheaply as possible because A. G. Becker & Co., Inc., was going to be paid * * * on the difference between the asset value and the market price, isn't that so?

A. That is so.

Further, the agreement between A. G. Becker & Co., Inc., and Atlas Corporation was predicated upon the assumption that the dividends upon the preferred stock of National Securities Investment Company due in October 1931 were to be passed.[141] On October 2, 1931, the preferred stockholders were informed both of the transfer of control of their corporation to Atlas Corporation and of the determination of

[140] Op. cit. supra, note 74, at 14378.

[141] Id., Commission's Exhibit No. 1462. The agreement provided:

> We [A. G. Becker & Co., Inc.] have advised you that the Company [National Securities Investment Company] is in such condition that the dividend next ordinarily due on its 6% Preferred Stock cannot be declared or paid, and this agreement has been entered in between us on the assumption that such dividend cannot be declared or paid (ibid.).

the directors of National Securities Investment Company to pass the dividend on its preferred stock.[142] The effect of this notice on the market price of the preferred stock will be discussed later. Although National Securities Investment Company was, under the Delaware law,[143] legally unable to pay the dividend on its preferred stock because of the impairment of the capital of the corporation allocable to its preferred stock, nevertheless, it was legally possible to reduce the capital of the corporation allocable to the preferred stock in order to create a surplus from which dividends could be paid.[144] However, this method of payment of dividends would be tantamount to a partial return of their capital to the stockholders. Irrespective of the merits of this method of paying "dividends," the preferred stockholders were given no opportunity to determine whether they desired such a procedure in preference to the passing of the dividend on their preferred stock. Instead, the dividend was passed. As a consequence of this and other reasons, the market price of the preferred stock declined. Mr. Schaffner, of A. G. Becker & Co., Inc., when examined upon the effect of the passing of the dividend on the market price of the preferred stock, testified:[145]

Q. Now, it was considered of sufficient consequence and importance to state that this whole agreement was being predicated upon the assumption that the dividend cannot be declared or paid.

A. Yes.

Q. And you concurred in that that there would be no declaration of a dividend?

A. Yes.

Q. Now, the mere announcement of that fact, that a dividend cannot be declared or paid, would cause a decline in the price of the preferred, isn't that so?

A. Yes. But that announcement would have had to be made whether we sold or didn't sell.

Q. Now, you say that that dividend could not be legally declared or paid, and I assume you predicated it upon the fact that the preferred was "under water?"

A. That is right.

Q. But under the laws of Delaware you could have restated the capital of the preferred and created a surplus and continued to pay the dividends.

A. Would that have been the sound thing to do?

Q. I don't know if it is any less sound than passing the dividends, causing the price of the preferred to flop from 70 to 31 and then pick the stock up for perfect strangers. You owed Atlas Corporation no duty, did you?

A. No; but I would say that it would have been a very unsound thing for us to have paid dividends out of the principal.

Q. Well, you have heard of investment trusts restating their capital to create surplus, isn't that so?

A. Yes.

Q. And it has been done in cases where there were deficits to create a surplus to take care of the deficit, isn't that so?

A. However, I am very definite in my statement that had we sold to the Atlas or not sold to the Atlas, we would have passed that dividend.

Q. You would have passed that dividend?

A. Yes.

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142 Id., Commission's Exhibit No. 1466.

143 Del. Rev. Code (1915), Ch. 65, Sec. 34.

144 Id., Sec. 28.

145 Op. cit. supra, note 74, at 14385.

Q. But under this agreement, you promised that you would not even attempt to restate the capital and make it possible for a dividend to be declared, isn't that so?

A. That is true.

Q. So that there was no request made of the stockholders of the National Securities Investment Company whether they would not rather see a restatement of the preferred capital and the creation of a surplus for the declaration of a dividend, was there?

A. No, I was very definite in that, that I wouldn't under any circumstances have paid that dividend, as long as the capital was impaired.

Q. Instead of not paying the dividend at a time when you were conducting your negotiations with Atlas Corporation you said that you wouldn't pay it and you promised under no circumstances would you pay it. You knew that as a necessary consequence of that action that there would be a decline in the market price of the preferred stock, and it was in the interest of Atlas Corporation to buy the preferred stock as cheaply as possible.

A. Yes, but that consequence would have come anyway.

As has been pointed out, A. G. Becker & Co., Inc., and George Pick & Co., Inc., had been operating a trading account in the preferred and common stock of National Securities Investment Company for the purpose of providing an "orderly" market for the company's share. After the sale by George Pick & Co., Inc., of its holdings of the common stock of National Securities Investment Company to A. G. Becker & Co., Inc., the latter continued to operate this "stabilization account" the operation of which had been justified as a "duty" owed to the stockholders by those who had sponsored the investment company, managed it, and distributed its securities to the public.[146] The agreement, nevertheless, between Atlas Corporation and A. G. Becker & Co., Inc., in effect provided for the cessation by A. G. Becker & Co., Inc., of any attempt to stabilize the market for, or otherwise deal in, the preferred stock of National Securities Investment Company except as brokers for the account of Atlas Corporation and at prices to be fixed by Atlas Corporation.[147] When examined as to the results of this agreement with respect to the control of the market price of the preferred stock of National Securities Investment Company by Atlas Corporation, Mr. Odlum testified:[148]

Q. The agreement itself, Mr. Odlum, states that Becker & Company "have agreed to refrain forthwith from competing with you [Atlas] in any fashion whatsoever in the purchase of shares of the common stock or warrants to purchase shares of the common stock of the company or shares of 6% preferred stock or from taking any position in the market for said shares or option warrants except as instructed by you." Here they undertake a solemn obligation that they would not buy a single share of stock except on your instructions, so Atlas Corporation was in complete control of that market so far as A. G. Becker & Co., Inc. were concerned, isn't that so?

A. That is true.

Robert C. Schaffner testified that on the consummation of the shift in control of National Securities Investment Company, A. G.

[146] Id., at 14373.
[147] Id., Commission's Exhibit No. 1462.
[148] Op. cit. supra, note 52, at 18009.

Becker & Co., Inc., became the agent of Atlas Corporation to purchase preferred stock for its account in the market, only at prices fixed by Atlas Corporation: [149]

A. We had no option to buy it cheap or high, but we simply bought it as brokers and bought it at prices that they indicated.

Q. That was at the market?

A. Sometimes they would give us orders under the market and sometimes they gave it at the market, but we simply acted as their brokers and bought it at prices that they told us.

The passing of the dividends on the preferred stock, the cessation of trading in that stock by A. G. Becker & Co., Inc., and a general market decline in the value of securities in September 1931 caused a sharp drop in the market price of the preferred stock of National Securities Investment Company. On September 28, 1931, the date of the agreement with Atlas Corporation, the preferred stock of National Securities Investment Company was selling at $50 a share. At September 30, 1931 (the agreement was dated September 28, 1931), the market price of the stock was $37 a share, although its asset value was $73.72 per share. From October 1931 to December 1934, the preferred stock of National Securities Investment Company consistently sold in the market at prices less than its asset value. The following schedule illustrates the differential between the market price and the asset value of the stock: [150]

Date	Market value			Asset value per share (end of month)
	High	Low	Last	
September 1931	64	36	37	$73.72
Nov. 30, 1931	40	31	40	70.90
June 4, 1932			26	53.80
December 1932	30	27½	28	57.47
December 1933			40	78.30
June 1934			51½	80.39
December 1934			59¼	79.66

Mr. Odlum attributed the immediate decline in the market price of the preferred stock to the fact that in September 1931 "England went off the Gold Standard," with a resulting drop in security values.[151] Mr. Schaffner, on the other hand, admitted that the cessation of the trading activities of preferred stock of National Securities Investment Company would cause a sharp drop in its market value.[152]

With the market price of National Securities Investment Company preferred stock in the control of Atlas Corporation, and with A. G. Becker & Co., Inc., engaged in acquiring such stock for Atlas Corpo-

[149] Op cit. supra, note 74. at 14390.

[150] *Bank and Quotation Record* and the reply to the Commission's questionnaire for National Securities Investment Company, Pt. I.

[151] Op. cit. supra, note 52. at 18029.

[152] Mr. Schaffner testified (op. cit. supra, note 74, at 14376):

Q. So it was to the interest of Atlas Corporation, if they were acquiring the stock in the open market, that the preferred stock sell as low as possible; isn't that so?
A. Yes.
Q. And one means to accomplish that end was that A. G. Becker & Company should immediately stop an orderly market in the preferred; isn't that so?
A. I think probably so.

ration, the latter was clearly in a position to derive substantial profits on its purchase of preferred stock. Atlas Corporation and its affiliated companies, from 1931 to 1935 (the year in which National Securities Investment Company was dissolved), purchased 92,974 shares of the preferred stock of National Securities Investment Company at an aggregate cost of $3,728,651.26. The asset value of this stock aggregated $6,184,817.85.[153] Of the 92,974 shares of National Securities Investment Company preferred stock purchased by Atlas Corporation, 74,072 shares were purchased through A. G. Becker & Co., Inc., as brokers.[154] On these purchases A. G. Becker & Co., Inc., received brokerage commissions totaling $44,670.27.[155]

By September 2, 1932, A. G. Becker & Co., Inc., had been paid $1,924,975.50 for its 641,658½ shares of the common stock of National Securities Investment Company, pursuant to and under the terms of the agreement of September 28, 1931.[156] This total payment represented the difference between 85% of the liquidating value and the cost of the preferred stock of National Securities Investment Company acquired by A. G. Becker & Co., Inc., as agent for Atlas Corporation. Atlas Corporation thus turned over to A. G. Becker & Co., Inc., for that firm's holdings of the common stock of National Securities Investment Company a portion of its ultimately realized profits on the acquisition of the preferred stocks of National Securities Investment Company from the public. The $1,924,975.50 was paid to A. G. Becker & Co., Inc., for stock which had no asset value and which had an average market value of $1.25 per share over the period in which it was purchased.[157] A. G. Becker & Co., Inc., were thus paid $1,122,902.38 above the average market price of their common stockholdings during the period of time in which Atlas Corporation was purchasing such stock. Furthermore, A. G. Becker & Co., Inc., emerged from its connection with National Securities Investment Company without sustaining any loss; rather, its connection with the investment company had been highly profitable. A. G. Becker & Co., Inc., had recovered the actual cost of its investment in the common stock of National Securities Investment Company[158] through

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[153] Op. cit. supra, note 52, at 18027. To derive the net gain in asset values to Atlas Corporation as a result of its purchases of the preferred stock of National Securities Investment Company, there must be added to the cost of such preferred stock the approximately $2,000,000 spent by Atlas Corporation in the purchase of the negative asset value common stock of National Securities Investment Company (Public Examination, Atlas Corporation, Commission's Exhibit No. 2001, at 190). On this basis the net asset value gain derived by Atlas Corporation on its purchases of the preferred stock of National Securities Investment Company was $456,000.

[154] Op. cit. supra, note 74, Commission's Exhibit No. 1462.

[155] Id., at 14392 and Commission's Exhibit No. 1465.

[156] Op. cit. supra, note 52, Commission's Exhibit No. 2001 (p. 175).

[157] Ibid.

[158] Mr. Schaffner testified (Public Examination, National Securities Investment Company, at 14359):

> Q. That block of stock (641,658½ shares sold to Atlas Corporation) cost A. G. Becker & Company approximately $1,800,000?
> A. One million nine.
> Q. So that, as far as A. G. Becker & Company was concerned, * * * they lost no money; isn't that so?
> A. Yes.
> Q. So we had the situation, as far as A. G. Becker is concerned, that they took no loss on their common stock?
> A. That is right.

its sale to Atlas Corporation. In addition, A. G. Becker & Co., Inc., had derived a profit of $276,366.09 as underwriting commissions on the original sale of the securities of the company and a profit of $579,183.67 as the result of trading in the investment company securities.[159]

When examined as to the nature of the entire transaction between A. G. Becker & Co., Inc., and Atlas Corporation; as to whether the agreement by its terms created a pecuniary interest in A. G. Becker & Co., Inc., antagonistic to the interests of the preferred stockholders of National Securities Investment Company; and as to whether the contract induced a breach of the fiduciary duty of A. G. Becker & Co., Inc., to protect the interest of the preferred stockholders of National Securities Investment Company, Mr. Schaffner testified:[160]

Q. * * * I am trying to visualize what your concept of your duty was with respect to the public by virtue of the fact that you underwrote or distributed the securities, sponsored the company, were officers and directors and owned the controlling block of stock. You won't deny that those factors imposed upon A. G. Becker & Co., Inc., and George Pick & Co., Inc., an obligation not to do anything to hurt the stockholders.

A. Oh, no question.

Q. In fact, would you say that these factors imposed upon A. G. Becker & Company a sort of affirmative, at least moral obligation to do everything they could to help the stockholders?

A. That is right.

* * * * * * *

Q. And this agreement [with Atlas] was made by A. G. Becker & Co., Inc., who had originally underwritten the [preferred] stock and originally sold it for $100; isn't that so?

A. Yes.

Q. At a time when, if the trust were liquidated, the stockholder would have gotten $72.

A. Yes, sir.

Q. And at a time when A. G. Becker pursuant to the written agreement promised not to effect any transactions in preferred stock except at the instructions of Atlas Corporation; isn't that so?

A. Yes.

Q. And done under circumstances by which A. G. Becker would stand to gain pecuniary benefit depending upon the cheapness at which they could pick up the preferred stock; isn't that so?

A. Yes.

Q. And necessarily, A. G. Becker & Co., and for that matter, Atlas Corporation, would only gain under those circumstances at the expense of the stockholder; isn't that so?

A. At the expense of the stockholder who sold——

Q. That is right.

A. Yes.

Q. And a stockholder who sold his stock was an individual "entitled" to $73.72. The peg is pulled, the stock declined, the stock is picked up, and the sponsor gets a cut on the difference between the asset value and the market value; isn't that so?

A. Yes.

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[159] See supra, pp. 1097 and 1100.

[160] Op. cit. supra, note 74, at 14350, 14381, 14395.

Q. * * * Let me ask you frankly, Mr. Schaffner, and I am going to discuss it a little more—looking back in retrospect, do you think that that agreement and the conduct of A. G. Becker & Co., Inc., under those circumstances was consonant with its duty that it owed to stockholders?

A. Well, I think there might be some question about it.

* * * * * * *

Q. * * * There was an asset value of $73.72 which the stockholder could have gotten and the other incontrovertible fact was that the sponsor agreed to pull the peg on their trading in that stock, and also promised under no circumstances would they declare a dividend and also promised inferentially at least that they would pick up stock as cheaply as possible because they had a pecuniary interest in picking up stock as cheaply as possible; isn't that true?

A. That is true.

Mr. Schaffner further testified:[161]

Q. * * * you are not defending that transaction, are you?

A. There are a lot of extenuating circumstances in connection with that that I would be glad to give you, if you would care to have them.

Q. Well, there may have been extenuating circumstances; and I am not interested in embarrassing you with respect to any financial condition or so forth, but looking at this transaction today, Mr. Schaffner, you don't undertake to defend it, do you?

A. I don't attempt to defend it. I am only wanting to say that in extenuation of it, that we did believe that even with this transaction, there was a better market for National Securities preferred, than there would have been had we continued in ownership.

In addition to effecting the cash purchases from the public of the preferred stock of National Securities Investment Company for the Atlas Corporation, A. G. Becker & Co., Inc., as will be described below, aided the Atlas Corporation in its exchange program to acquire National Securities Investment Company's securities.

On October 2, 1931, A. G. Becker & Co., Inc. caused the members of the Board of Directors of National Securities Investment Company, all of whom were its nominees, to resign, and simultaneously caused the election, as directors of the company, of nominees of Atlas Corporation. Atlas Corporation thereby became in effect a "trustee" for the preferred stockholders of National Securities Investment Company. Nevertheless Atlas Corporation was seeking to purchase or acquire by exchange offer the public holding of the preferred shares of National Securities Investment Company at prices less than the asset value of such shares. And by the agreement with A. G. Becker & Co., Inc., Atlas Corporation had set up the machinery

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[161] Id., at 14393. When examined on this entire transaction, Mr. Odlum testified (op. cit. supra, note 52, at 17994):

Q. Let me ask you a broad elementary question, Mr. Odlum. Of course, it is wrong for a person to violate his fiduciary obligation to the stockholders?

A. Yes.

Q. Do you consider it equally wrong for a person to induce that breach of fiduciary obligation?

A. That is rather a difficult question to say "yes" or "no" to. And I think I would have to have particular facts to answer that question. I think it is wrong for anybody to do anything that is wrong, which is the elementary answer to that.

Q. Don't you consider it equally wrong for an individual to induce somebody else to do a wrong?

A. Well, if somebody induces somebody to do a wrong, I should say that somebody had some degree of participation in the wrong-doing.

Q. And have some element or degree of culpability?

A. Yes.

for the accomplishment of its purpose to acquire these shares. Mr. Odlum testified that the sum of his duty to the preferred stockholders of National Securities Investment Company was an obligation to offer them a fair price for their shares and to manage the company fairly.[162]

Atlas Corporation purchased 92,974 shares of preferred stock of National Securities Investment Company at the average equivalent of 68.1% of the liquidating value of the stock when purchased.[163] Mr. Odlum testified that the price was "fair" because during the period of these purchases similar preferred stocks of other investment companies were selling at a market price equivalent to only 56.9% of their asset values.[164] The net profit made by Atlas Corporation on its purchases of the preferred stock of National Securities Investment Company was $456,000.[165]

Under the management of Atlas Corporation the asset value of the preferred stock of National Securities Investment Company increased from $73.72 to approximately $95 a share at the date of its dissolution in 1935.[166] However, substantially all the increase in the asset value of this preferred stock accrued to Atlas Corporation as the holder of substantially all of the preferred stock of National Securities Investment Company and pro rata to those preferred stockholders of National Securities Investment Company who exchanged their stock for Atlas Corporation's securities. At the date of the dissolution of the National Securities Investment Company in 1935, Atlas Corporation had acquired by purchase and exchange offers 133,308 shares, or 95% of the outstanding preferred stock of National Securities Investment Company.[167]

Although Atlas Corporation had entered into the agreement of September 28, 1931 with A. G. Becker & Co., Inc., the obligations of Atlas Corporation under the agreement were carried out not by Atlas Corporation but by Chatham Phenix Allied Corporation,[168] another investment company, control of which had been acquired by Atlas Corporation one month prior to its acquisition of control of National Securities Investment Company.[169] On October 2, 1931, Chatham Phenix Allied Corporation advanced the "loan" of $1,000,000 to A. G. Becker & Co., Inc., and received as "collateral" therefor the 400,000 shares of National Securities Investment Company common stock,[170] which had no asset value and a nominal market value. The "loan," as has been indicated, could be satisfied only by realizing on 333,333⅓ shares of the collateral at $3 per share and in effect constituted a purchase of the shares. The loss to Chatham Phenix Allied Corporation of $1,000,000 in asset values could only be retrieved if A. G. Becker & Co., Inc., succeeded in purchasing for the account of Chatham Phenix Allied Corporation the preferred stock of National Securities Investment Company at a sufficient discount

[162] Id., at 18026 and 18064.
[163] Id., at 18027.
[164] Ibid.
[165] See note 153, supra.
[166] Id., Commission's Exhibit No. 2001 (p. 191).
[167] Id., Commission's Exhibit No. 2001 (p. 192).
[168] Id., Commission's Exhibit No. 2001 (p. 170).
[169] See infra, pp. 1142–57.
[170] Op. cit. supra, note 52, Commission's Exhibit No. 2001 (p. 170).

from asset value to enable Chatham Phenix Allied Corporation to profit on these preferred stock purchases. On October 2, 1931, Atlas Corporation held only approximately 40% of the outstanding capital stock of Chatham Phenix Allied Corporation.[171]

From September 1931 to December 8, 1933, when it was dissolved, Chatham Phenix Allied Corporation purchased 82,672 shares of the preferred stock and 691,219½ shares of the common stock of National Securities Investment Company.[172] The common shares purchased included the 641,658½ purchased from A. G. Becker & Co., Inc., for $1,924,975.50. The total cost of both the preferred stock and common stock of National Securities Investment Company to Chatham Phenix Allied Corporation was $4,948,560.61.[173] The combined market value of these shares in December 1933 was $5,207,735.73.[174] In other words the Chatham Phenix Allied Corporation had made a profit by December 1933 (based on market values at that date) of $259,175.12 on its purchases of the securities of National Securities Investment Company.

On the dissolution of Chatham Phenix Allied Corporation the calculation of the distributive share of the corporate assets to which each stockholder was entitled was based on the market value of most of its portfolio securities.[175] However, the securities of National Securities Investment Company held by Chatham Phenix Allied Corporation had an actual asset value of $6,643,217.60 on December 31, 1933, as compared to their cost of $4,948,560.61, to Chatham Phenix Allied Corporation.[176] The difference of $1,694,656.99 between the asset value of these securities and their cost accrued largely to Atlas Corporation. Although on dissolution of Chatham Phenix Allied Corporation its stockholders were permitted to take their distributive share of the corporate assets either in cash or in portfolio securities, only 2,466 shares of the preferred and 20,610½ shares of the common stock of National Securities Investment Company were distributed in kind as liquidating dividends or sold to provide cash to be paid as liquidating dividends to minority stockholders of Chatham Phenix Allied Corporation.[177] On the other hand, Atlas Corporation, as the holder of 96.71% of the securities of Chatham Phenix Allied Corporation,[178] received as liquidating dividends 79,031 shares of the preferred stock and 660,783 shares of the common stock of National Securities Investment Company.[179] Thus only Atlas Corporation and, to some extent, those Chatham Phenix Allied Corporation stockholders who had exchanged their stock for Atlas Corporation securities benefited substantially by the investment of Chatham Phenix Allied Corporation in National Securities Investment Company.

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[171] Id., Commission's Exhibit No. 2001 (pp. 113, 121).

[172] Id., Commission's Exhibit No. 2001 (p. 175).

[173] Id., Commission's Exhibit No. 2040.

[174] The market value of the preferred stock of National Securities Investment Company in December 1933 was $40⅛ per share. The market value of the common stock of National Securities Investment Company in December 1933 was $1 per share (*Bank and Quotation Record.* December 1933).

[175] Op. cit. supra, note 52, Commission's Exhibit No. 2001 (p. 122).

[176] Reply to the Commission's questionnaire for National Securities Investment Company, Pt. I. The market value of the preferred stock was $40⅛ per share and its asset value at the same date was $78.50 per share.

[177] Op. cit. supra, note 52, Commission's Exhibit No. 2001 (p. 183).

[178] Ibid. (p. 121).

[179] Ibid. (p. 183).

Minority stockholders of Chatham Phenix Allied Corporation who accepted their distributive share of the assets of Chatham Phenix Allied Corporation in cash derived comparatively little benefit from the purchase by their corporation of the securities of National Securities Investment Company.

(5) EXCHANGE OFFERS FOR NATIONAL SECURITIES INVESTMENT COMPANY SECURITIES

In addition to its own purchases and the purchases by Chatham Phenix Allied Corporation of the securities of National Securities Investment Company, Atlas Corporation also acquired such securities as the result of exchange offers. On June 4, 1932, Atlas Corporation, in a circular letter to the stockholders of National Securities Investment Company, offered to exchange for each share of National Securities Investment Company preferred stock a unit of Atlas Corporation securities consisting of two-thirds of a share of its preference stock, one share of its common stock, and one of its perpetual option warrants to purchase one share of its common stock at $25 per share.[180]

For each share of the common stock of National Securities Investment Company, Atlas Corporation offered to exchange an option warrant to purchase one-third of a share of its common stock at any time at the price of $25 per share. Neither of these securities had any asset value,[181] but the market value of the Atlas Corporation warrant offered was approximately equivalent to the market value of a share of common stock of National Securities Investment Company. The market value of the unit of Atlas Corporation securities offered for the preferred stock of National Securities Investment Company exceeded the market value of the preferred stock of National Securities Investment Company by $2.80, but the asset value of each share of the preferred stock of National Securities Investment Company was $17.50 in excess of the asset value of the Atlas Corporation securities offered in exchange. In other words, preferred stockholders of National Securities Investment Company who accepted the offer suffered a gross loss in asset value of $17.50 per share of their stock but gained $2.80 in market value.[182]

As a result of its exchange offer, Atlas Corporation acquired 23,458 shares of the preferred stock and 56,230 shares of the common stock of National Securities Investment Company. On the exchange of securities preferred stockholders of National Securities Investment Company who accepted the offer suffered a gross loss in asset values of $420,569, but gained on the basis of a difference of $2.80 a share, a total of $65,682.40 in market value.[183]

On November 23, 1932, Atlas Corporation entered into an agreement with A. G. Becker & Co., Inc., wherein the latter agreed to solicit preferred and common stockholders of National Securities Investment Company to exchange their shares for the securities of Atlas Corporation. A. G. Becker & Co., Inc., was to receive a commission of $2 for each share of National Securities Investment Com-

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[180] Id., Commission's Exhibits Nos. 1970, 2001 (pp. 176–8).

[181] Ibid.

[182] Id., Commission's Exhibit No. 2001 (p. 178).

[183] Ibid. (p. 179).

pany preferred stock exchanged for Atlas Corporation securities. It was understood that "sufficient time will be allowed us [A. G. Becker & Co., Inc.] to approach substantially all of the present holders" of the stock of National Securities Investment Company.[184] Thus, the original sponsors of the investment company, the underwriters of its preferred stock, its former managers, former officers and directors, and former owners of the controlling block of stock had a pecuniary interest in inducing preferred stockholders of National Securities Investment Company to exchange their securities for Atlas Corporation securities. On December 15, 1932 Atlas Corporation offered to exchange a unit of its securities, consisting of eight-tenths of a share of its preference stock and one and three-quarters of its option warrants for each share of National Securities Investment Company preferred stock. For each share of the common stock of National Securities Investment Company, Atlas Corporation offered to exchange one-third of one of its option warrants. Although the offer stated that "A. G. Becker & Co., Inc., of Chicago and New York, have requested us [Atlas] to make the offer," the offer did not reveal that A. G. Becker & Co., Inc., was to receive commissions for its services.[185]

On the basis of market values, the offers, as was the case in most of the Atlas Corporation exchange offers, were favorable to National Securities Investment Company stockholders. The Atlas Corporation securities offered for the National Securities Investment Company preferred stock had a market value which exceeded the market value of the preferred stock of National Securities Investment Company by $1.21 a share. The Atlas Corporation warrants offered for the common stock of National Securities Investment Company had a market value which exceeded the market value of the common stock of National Securities Investment Company by 42 cents a share.[186] However, as has been pointed out, the transactions of Atlas Corporation in the securities of National Securities Investment Company were virtually the "market" in those securities.

In terms of asset value, however, the preferred stockholders of National Securities Investment Company who accepted the exchange offer suffered a gross loss in asset value of $17.27 a share of their preferred stock.[187] Neither the common stock of National Securities Investment Company nor the Atlas Corporation warrants offered in exchange had any asset value.[188]

As a result of this offer, Atlas Corporation acquired 19,775 shares of the preferred stock and 86,475 shares of the common stock of National Securities Investment Company. The total gross asset loss to National Securities Investment Company preferred stockholders who accepted the Atlas Corporation offer was approximately $395,771.[189]

On June 13, 1933, Atlas Corporation again presented an offer of exchange to the stockholders of National Securities Investment Com-

[184] Id., Commission's Exhibit No. 1990.
[185] Id., Commission's Exhibits Nos. 1970, 2001 (p. 178).
[186] Id., Commission's Exhibit No. 2001 (p. 179).
[187] Ibid.
[188] Ibid.
[189] Ibid.

pany.[190] In this offer, Atlas Corporation agreed to exchange 2.6 shares of its common stock for each share of National Securities Investment Company preferred stock and one-third of an Atlas Corporation warrant for each share of common stock of National Securities Investment Company.[191] At the date of the offer the asset value of the National Securities Investment Company preferred stock was $71.72, as compared with an asset value of $27.82 for the 2.6 shares of Atlas Corporation common stock offered in exchange for the preferred stock.[192] In other words, National Securities Investment Company preferred stockholders accepting the offer suffered a gross loss of $43.90 a share of their preferred stock. However, the market value of the Atlas Corporation securities exceeded the market value of the preferred stock of National Securities Investment Company by $15.10.[193] The common stock of National Securities Investment Company and the warrants of Atlas Corporation offered in exchange had no asset value but were of approximately equal market value.[194]

As a result of its exchange offer of June 13, 1933, Atlas Corporation acquired 854 shares of the preferred stock and 7,847 shares of the common stock of National Securities Investment Company. On these exchanges Atlas Corporation derived an asset gain of $16,381.75.[195]

Acceptance of both the Atlas Corporation offers of December 15, 1932, and June 13, 1933, was actively solicited by A. G. Becker & Co., Inc., and that firm received as commissions from Atlas Corporation a total of $50,676.[196]

By July 24, 1935, as a result of its cash purchases and exchange offers, Atlas Corporation had acquired 133,308 shares of the preferred stock and 855,985½ shares of the common stock of National Securities Investment Company at a total cost of $7,754,372, as per Atlas Corporation's books after eliminating all intercompany transactions between Atlas Corporation and its subsidiaries and deducting the total asset gains of $832,722 made by Atlas Corporation on its exchange offers for the securities of National Securities Investment Company. The holdings of Atlas Corporation in National Securities Investment Company at that time constituted 97% of that company's outstanding preferred stock and 92% of its outstanding common stock.[197]

On July 24, 1935, Atlas Corporation caused National Securities Investment Company to be dissolved. Net assets of the investment company then totaled $13,145,780.62, an amount sufficient to pay $95.41 a share on each of the company's outstanding preferred shares.[198] Since the preferred stock was entitled in liquidation to a prior claim against the corporate assets to the extent of $100 and accrued dividends, the common stockholders of the company were

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[190] Id., Commission's Exhibits Nos. 2001 (p. 180), 1970.

[191] Ibid. The offering letter did not reveal the comparative asset values of the shares to be exchanged. It merely stated that the market value of the common stock of Atlas Corporation on June 12, 1933, was $18½ (ibid.).

[192] Id., Commission's Exhibit No. 2001 (p. 181).

[193] Ibid.

[194] Ibid.

[195] Ibid.

[196] Id., Commission's Exhibit No. 1991.

[197] Id., Commission's Exhibit No. 2001 (pp. 189–91).

[198] Ibid.

entitled to no share of the corporate assets. However, the Atlas Corporation, from its own share of the assets of National Securities Investment Company, paid $1.50 a share to the minority common stockholders of that company.

Atlas Corporation received, as a liquidating dividend on its holdings of the securities of National Securities Investment Company, cash and securities valued at market totaling $12,606,044.[199] Thus, the net profits to Atlas Corporation on its investment in National Securities Investment Corpany's preferred and common stocks totaled $4,852,000. Of this entire profit $1,289,000 represented the asset gains at the time of acquisition on the preferred and common stocks of National Securities Investment Company which Atlas Corporation had acquired by purchase or exchange. To some extent, those National Securities Investment Company stockholders who exchanged their shares for Atlas Corporation securities by becoming stockholders of Atlas Corporation participated in this gain since they shared in the ultimate profits made by Atlas Corporation.

b. Atlantic and Pacific International Corporation—Morris Plan Corporation—David M. Milton

On April 26, 1928, Atlantic and Pacific International Corporation was incorporated in Maryland[200] to function as an investment company, and its charter sharply restricted the investment policies which could be pursued by its management. Among the restrictions was a prohibition against the investment of more than 25% of the corporation's general funds in the securities of banking institutions or investment organizations.[201]

The authorized capitalization of the corporation consisted of a preferred stock, a Class A common stock, and a Class B common stock. The Class A common stock was entitled on liquidation to receive the net amount received by the corporation on its sale before any portion of the assets was to accrue to the Class B common stock.[202] The preferred stock had voting rights only on default of four consecutive dividend payments.[203] The Class A common stock and Class B common stock each had one vote per share.[204]

The preferred stock and the Class A common stock of the corporation were sold to the public.[205] In excess of 95% of the 146,250 shares of the Class B common stock which were outstanding as at December 31, 1931,[206] had been acquired in 1930 by United States Shares Corporation,[207] all of whose common stock, representing 50% of the total

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[199] Ibid. Of this amount, $3,047,777.31 constituted cash and $9,558,266.97 was represented by the market value of securities acquired from National Securities Investment Company (ibid.).

[200] *Moody's Manual of Investments, Banks, etc.*, 1929, p. 2831.

[201] Public Examination, The Equity Corporation, at 8078–9 and Commission's Exhibit No. 729.

[202] Id., Commission's Exhibit No. 729.

[203] Ibid.

[204] Ibid.

[205] *Moody's Manual of Investments, Banks, etc.*, 1929, p. 2831; op. cit. supra, note 201, at 8080.

[206] Op. cit. supra, note 201, Commission's Exhibit No. 727.

[207] Id., at 8070 and Commission's Exhibit No. 734; *Moody's Manual of Investments, Banks, etc.*, 1932, p. 1590.

voting stock, was owned by holding companies controlled by a group of individuals headed by Gero von S. Gaevernitz and Donald J. Hardenbrook.[208] Members of the Gaevernitz group personally owned all of the Class A common shares of United States Shares Corporation. These Class A shares constituted the remaining 50% of the voting securities of United States Shares Corporation.[209]

Mr. Hardenbrook and Mr. Gaevernitz, in December 1931, were president and vice president, respectively, of Atlantic and Pacific International Corporation. They also were directors and members of the executive committee of the corporation. Travis H. Whitney, another member of the Gaevernitz group, was also a member of Atlantic and Pacific International Corporation's executive committee.[210]

By December 31, 1931, Atlantic and Pacific International Corporation's net operating losses totaled $2,290,254.08. The corporation's assets, based on the market value of its securities and on the cost of nonmarketable securities, totaled $2,470,143.[211] Against these assets there existed the claims of the holders of the company's outstanding 43,168 shares of preferred stock, its outstanding 101,598 $^{53}/_{80}$ shares of Class A common stock, and its outstanding 146,250 shares of Class B common stock.[212] The preferred stock of the corporation was entitled, on a dissolution of the corporation, to $50 a share, or a total of $2,158,400. In addition, accrued unpaid dividends on the preferred stock as at December 31, 1931, totaled $6.30 a share, or a total of $271,958.[213] The total claim on the assets of the corporation represented by its outstanding preferred stock was, therefore, $2,430,358. After satisfaction of the preferred stock claim, the corporation's assets as at December 31, 1931, would have been sufficient to pay only approximately 40 cents a share to the Class A stockholders who were entitled on liquidation to receive in preference to the Class B stock the amount which they had invested in the enterprise.[214] The amount paid into the corporation by the Class A stock was approximately $20 a share. As a consequence, the Class B stock, which was substantially all owned by the Gaevernitz group and controlled United States Shares Corporation, had no asset value.

Most of Atlantic and Pacific International Corporation's assets, as of December 31, 1931, were extremely liquid. Of its total assets at market value, $1,952,461, or 80%, consisted of cash or U. S. Government bonds;[215] the market value of domestic corporate securities held by the corporation totaled $433,225.[216] The remaining assets of the corporation consisted of foreign securities, largely those of German political subdivisions which had no market.[217] These foreign securities were carried on the corporation's books at a value of

[208] Op. cit. supra, note 201, at 1068 and Commission's Exhibits Nos. 727 and 734; *Moody's Manual of Investments, Banks, etc.*, 1931, pp. 2791 and 2794–6.
[209] Ibid.
[210] Op. cit. supra, note 201, Commission's Exhibit No. 727.
[211] Ibid.
[212] Ibid.
[213] *Moody's Manual of Investments, Banks, etc.*, 1932, p. 1591.
[214] See supra, p. 1120.
[215] Op. cit. supra, note 201, Commission's Exhibit No. 727.
[216] Ibid.
[217] Ibid.

$477,616,[218] representing substantially the cost of such securities to the corporation.[219]

In September 1931 the liquid character of the assets of Atlantic and Pacific International Corporation became of interest to Morris Plan Corporation of America, which then was in immediate need of cash. Morris Plan Corporation was then directly or indirectly liable upon $4,898,000 principal amounts of notes and debentures which it had issued or which had been issued by its wholly-owned subsidiaries.[220] Of these notes, $1,082,500, in principal amount, were to mature late in 1931 and early in 1932. To meet this obligation the Morris Plan Corporation had only $26,507 in free cash.[221] The remainder of its assets consisted of its right to the exclusive use of the so-called "Morris Plan" of industrial banking which the corporation valued at $1,000,000 as at September 30, 1931, and of other assets consisting largely of the stock of the various Morris Plan Banks having a book value of approximately $11,000,000. However, substantially all of these assets taken at book value were pledged as collateral for the outstanding $4,898,000 of notes issued directly or indirectly by the Morris Plan Corporation.[222]

Apparently, a public offering of Morris Plan Corporation securities was not then feasible, especially in view of the market behavior of the notes of Morris Plan Corporation which were then selling at a 50% discount from their face value.[223]

Late in 1931 John Speed Elliott succeeded in interesting Arthur Morris, the president of Morris Plan Corporation, in the possibilities of acquiring the $1,950,000 in cash and U. S. Government bonds owned by Atlantic and Pacific International Corporation by selling to that corporation securities of Morris Plan Corporation.[224]

In order to accomplish the sale of Morris Plan Corporation's securities to Atlantic and Pacific International Corporation for $1,950,000, a sum which constituted the value of all the quick assets of the corporation, an amendment to Atlantic and Pacific International Corporation's charter was necessary. It will be recalled that Atlantic and Pacific International Corporation's charter forbade the investment of more than 25% of its assets in the securities of banking institutions.[225] The contemplated purchase of the Morris Plan Corporation securities would violate this charter provision.

An amendment of the charter of Atlantic and Pacific International Corporation to remove these investment restrictions would require the vote by classes of two-thirds of each class of the voting securities of the corporation.[226] All of the outstanding securities of Atlantic and Pacific International Corporation, the preferred stock, Class A stock, and Class B stock, then had voting rights, the right of the

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[218] Ibid.

[219] Ibid.

[220] *Moody's Manual of Investments, Banks, etc.*, 1936, p. 2609; op. cit. supra, note 201, Commission's Exhibit No. 728.

[221] Ibid.

[222] Ibid.

[223] Op. cit. supra, note 201, Commission's Exhibit No. 737.

[224] Id., at 8120.

[225] Id., at 8080.

[226] Id., Commission's Exhibit No. 729.

preferred stock to vote having accrued because of a default in the payment of four consecutive dividends.[227]

Mr. Morris' intention was to acquire two-thirds of the preferred stock and two-thirds of the Class A common stock of Atlantic and Pacific International Corporation by means of an exchange offer of a newly created Morris Plan Corporation preferred stock and common stock. The two-thirds of the securities of each of these classes of stock so acquired were to be voted by Morris Plan Corporation in favor of an amendment to Atlantic and Pacific International Corporation's charter eliminating the investment restrictions which interfered with the contemplated sale of Morris Plan Corporation's securities to Atlantic and Pacific International Corporation.

Mr. Morris, however, was informed by his counsel, Ellery C. Huntington, a partner in the law firm of Satterlee & Canfield, that the consent of two-thirds of the holders of the Class B stock of Atlantic and Pacific International Corporation would be necessary to the contemplated amendment of Atlantic and Pacific International Corporation's charter.[228] Mr. Morris accordingly began negotiations with the group of individuals headed by Mr. Gaevernitz, who controlled, through United States Shares Corporation, in excess of 90% of the Class B stock of Atlantic and Pacific International Corporation.[229]

As a result of these negotiations, Mr. Gaevernitz and his associates agreed to "go along" with the plan of Morris Plan Corporation.[230] As the price of this cooperation, however, Morris Plan Corporation apparently agreed to purchase at a price of approximately $250,000 [231] certain nonmarketable German securities owned by United States Shares Corporation [232] and by Atlantic and Pacific International Corporation—securities which Mr. Morris referred to in his testimony as "Eskimos." [233] Morris Plan Corporation also agreed to exchange its preferred and common stock for the common stock of United States Shares Corporation [234] which, it will be recalled, was held by two holding companies controlled by Mr. Gaevernitz and his associates. The purchase by Morris Plan Corporation of the frozen German securities held by United States Shares Corporation apparently would enhance the asset value of its Class A shares.[235] As has been pointed out, Mr. Gaevernitz and his associates owned all the Class A shares of United States Shares Corporation.[236] These shares represented 50% of the voting stock of United States Shares Corporation. United States Shares Corporation in turn owned 95% of the Class B shares of Atlantic and Pacific International Corporation which represented control of that corporation. Thus, control of Atlantic and Pacific International Corporation would still remain in the Gaevernitz group by virtue of their control of the Class A shares of United States Shares Corporation.

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[227] *Moody's Manual of Investments, Banks, etc.,* 1932, p. 1571.
[228] Op. cit. supra, note 201, at 8080.
[229] Id., at 8122.
[230] Id., at 8123.
[231] Id., at 8125.
[232] Id., Commission's Exhibit No. 728.
[233] Id., at 8124–5.
[234] Id., Commission's Exhibit No. 728.
[235] Id., at 8126.
[236] Ibid.

The obligations of Morris Plan Corporation were conditioned, however, upon the acceptance of exchange offers by the holders of two-thirds of the preferred and Class A stock of Atlantic and Pacific International Corporation.[237] Thus, an incentive was created in Mr. Gaevernitz and his associates to foster the Morris Plan Corporation's exchange offer.

Mr. Morris, in his testimony, admitted that the cooperation of Mr. Gaevernitz and his associates had been obtained by the promise of Morris Plan Corporation to purchase the frozen assets of United States Shares Corporation—purchases which would increase the value of the Class A shares of United States Shares Corporation held by Mr. Gaevernitz and his associates. Mr. Morris testified:[238]

A. The only thing Gaevernitz insisted on was that we would agree to take on these frozen assets that we had nicknamed "Eskimos" and which practically had no market value, at a price that had been set by him. My recollection of the price is that it was between two and three hundred thousand dollars * * *.

Q. Now, Mr. Morris, Mr. von Gaevernitz', controlled stock had no asset value at all—it was just that it was in the key position; isn't that so—it controlled the situation?

A. Well, the record will show that. You mean those "B" shares of Atlantic and Pacific?

Q. Yes.

A. Oh, they were under water.

Q. They were under water?

A. Yes.

Q. And the "A" shares that controlled the situation, they were under water and valueless, too, except that he could control the United States Shares Corporation with them—isn't that so? I am talking about the "A" stock of United States Shares Corporation, the block that he held that controlled the situation.

A. I don't remember.

Q. Isn't it obvious, Mr. Morris, that the reason he wanted you to overpay two or three hundred thousand dollars was to give some value to the stock that he held—isn't that so?

A. I imagine so.

Having thus secured the cooperation of the management of Atlantic and Pacific International Corporation, on December 1, 1931, Morris Plan Corporation offered to exchange its preferred and common stocks for the preferred and Class A stock of Atlantic and Pacific International Corporation.[239]

Accompanying the offer of Morris Plan Corporation was a letter signed by Donald J. Hardenbrook, the president of Atlantic and Pacific International Corporation, which stated:[240]

Due to the continued unsettled conditions in the securities markets throughout the world, dividends on the Preferred Stock of your Corporation have been passed for almost two years and the asset value of the Class "A" Common Stock has been almost completely eliminated.

In view of these conditions and the uncertain future outlook for small investment companies, your board is of the opinion that this offer which provides a

[237] Id., Commission's Exhibit No. 728.
[238] Id., at 8125–6.
[239] Id., Commission's Exhibit No. 728.
[240] Ibid.

direct and immediate opportunity whereby stockholders may exchange their shares for those of a larger corporation capable of paying dividends and whose activities are based on a time tested stable business with greater possibilities of future development, is one which should be submitted to stockholders for consideration.

The letter of Mr. Hardenbrook, who, as has been stated, was a member of the Gaevernitz group, also pointed out that "United States Shares Corporation owned in excess of 90% of the outstanding shares of Class B common stock of this corporation [Atlantic and Pacific International Corporation] and three of its directors are directors of this corporation." [241] The names of these directors, of whom Mr. Hardenbrook was one, were not revealed. The letter then went on to state: [242]

United States Shares Corporation has outstanding common stock, Class "A" stock and options to purchase common stock. An offer has been made by the Morris Plan Corporation of America to said United States Shares Corporation which contemplates that upon the happening of certain contingencies, including the acceptance of the enclosed offer of the Morris Plan Corporation of America by the stockholders of this corporation and the liquidation of certain assets of this corporation and of said United States Shares Corporation, an offer will be made to the stockholders of United Holding Corporation and/or United States Financial Holding Corporation (which together own all of the issued and outstanding common stock of United States Shares Corporation) to exchange their stock for preferred stock * * * and/or common stock of the Morris Plan Corporation of America.

It will be noted that the letter failed to disclose that Mr. Hardenbrook, Mr. Gaevernitz, and their associates owned all of the Class A stock of United States Shares Corporation and that they also controlled United Holding Corporation and United States Financial Holding Corporation, which, as the letter states, controlled all of the common stock of United States Shares Corporation.[243] Nor did the letter reveal their pecuniary interest in the increase in the asset value of their Class A common stock of United States Shares Corporation which would accrue to Mr. Hardenbrook and his associates as a result of the purchase by Morris Plan Corporation of the frozen German securities held by United States Shares Corporation.

Although Mr. Hardenbrook's letter to the stockholders of Atlantic and Pacific International Corporation did not, in so many words, recommend the acceptance of the offer of Morris Plan Corporation, the laudatory statements made with respect to Morris Plan Corporation implied a recommendation of acceptance of the exchange offer.

Immediate opposition developed to the offer of Morris Plan Corporation. A group of Philadelphia investment bankers who had distributed Atlantic and Pacific International Corporation preferred and Class A stock in Philadelphia [244] formed a protective committee to oppose the Morris Plan offer.[245] This committee sent circular

[241] Ibid.
[242] Ibid.
[243] Ibid.
[244] Id., at 8085.
[245] Id., at 8087.

letters to Atlantic and Pacific International Corporation stockholders on December 9, 1931, and December 19, 1931, urging nonacceptance of the Morris Plan offer.[246] The committee asserted that the market value of the Morris Plan Corporation securities offered for the Atlantic and Pacific International Corporation preference stock would not exceed $18, whereas the quick assets of Atlantic and Pacific International Corporation, if the company were dissolved, were sufficient to pay $40 on each share of preferred stock.[247] The committee demanded the dissolution of Atlantic and Pacific International Corporation.[248]

To these letters of the protective committee, Mr. Hardenbrook replied on December 18, 1931.[249] Mr. Hardenbrook pointed out the impossibility of liquidating Atlantic and Pacific International Corporation without the consent of its Class A and Class B stockholders. His letter failed to mention that he and his associates controlled the Class B stock. The letter further stated:[250]

> The board of directors of this corporation [Atlantic and Pacific International Corporation] was of the opinion that the offer of the Morris Plan Corporation of America should be submitted to stockholders for their consideration as it provided an opportunity whereby the preferred stockholders could exchange their shares for a dividend paying preferred stock backed up by a three year dividend guaranty reserve. At the same time, the Class A common stockholders are given the opportunity of exchanging their shares, which only have a nominal value for a common stock in the Morris Plan Corporation of America having a book value of approximately $2.00 per share and thus becoming stockholders in a much larger company showing substantial earning power even under present conditions and whose activities are based on a business which has been tried and found profitable for a period of years.

Although Mr. Hardenbrook in his testimony denied that the quoted paragraph in his letter constituted a recommendation of the Morris Plan Corporation offer,[251] it is obvious that the statements made were highly favorable to Morris Plan Corporation.

In addition to circularizing the Atlantic and Pacific International Corporation stockholders in opposition to the Morris Plan Corporation offer, the protective committee of investment bankers took legal steps to block the plans of the Morris Plan Corporation and the Gaevernitz-Hardenbrook group. The committee applied to the Maryland Circuit Court in Baltimore for an injunction restraining any amendment to the charter of Atlantic and Pacific International Corporation which would permit it to purchase $1,950,000 of the securities of Morris Plan Corporation.[252] Judge O'Dunne of the Baltimore Circuit Court dismissed the proceedings as prematurely brought in view of the fact that no attempt had been made to amend Atlantic and Pacific International Corporation's charter.[253] However, he expressly granted to the plaintiffs the right to renew their

[246] Id., Commission's Exhibit No. 737.
[247] Ibid.
[248] Ibid.
[249] Id., Commission's Exhibit No. 726.
[250] Ibid.
[251] Id., at 8145, 8212.
[252] Id., at 8090.
[253] Id., Commission's Exhibit No. 730.

application for an injunction if an amendment to Atlantic and Pacific Internatinal Corporation's charter became imminent, and in his oral opinion he intimated his disapproval of the scheme of the Morris Plan Corporation and of the management of Atlantic and Pacific International Corporation. With reference to the activities of the latter, Judge O'Dunne pointedly remarked that:[254]

It is a very artfully put clause on the fourth page of the Morris Plan offer, in which they [the Hardenbrook-Gaevernitz group] do disclose the fact of the existence of the United States Shares Corporation owning 90% of the stock of the B Class. We know in corporate management wherever bold and raw things are put over successfully and prove beneficial, even though parties are most apprehensive of the result at the time, when they work out successfully, everybody says, "Captain of Finance"—if they fail, there are nastier terms used. However, when they get into an equity court, the trustees of a corporation are held to a strict accountability for the discharge of their trust, much stricter than officers of a corporation hold them in the actual administration of it in most cases, I think.

Judge O'Dunne, in a "homely illustration" of the facts alleged in the bill of complaint before him, also stated:[255]

It impressed me very similarly to a girl, free, white, and twenty-one, who had got four millions on her person in cash and liquid assets and who finds courting her a dapper young man named Morris Plan, who alleges that he is a good deal richer than she is and gives her an inventory of his assets as worth about twelve million dollars and against the real cash she has got on her of four million and when she asked where is it, well he says, I have it hocked right now, most of it; some of it is my trade name * * * and the rest of it is valuable equity that you will have to take on faith. Now she called up the chief of police and says: "Chief, there's a man in my house, in my parlor who wants to marry me. I distrust his motives; I am afraid of his appearance—I doubt his assets and I think he is after my fortune, and if he gets that, I think he is fraudulent enough to ruin me and rob me of my assets and take all I have got and I am not going to marry him because I don't trust him. I won't accept his offer, I don't think it is bona fide and I wish you to arrest him and lock him up and hold him until we see what is the matter with him." So the chief would say: "Has he threatened to steal your money by force? Has he done you any violence or has he tried to?" The answer would be, "No, but I feel he is going to seduce me and that's the next thing that is going to happen and my temperature is already up." Now, I think the chief would have to tell her, "I am powerless to give you relief at this stage. I think you are in danger of what you believe is the true portrayal of the conditions, but unless he either robs you by fraud, deceit or force or seduces you, you don't have to accept his offer of marriage, which you distrust and you are not without fair justification. But I can't lock him up on suspicion even if I were inclined to agree that you are about to be seduced if you don't watch your step."
That's about what I think this case is.

Despite the activities of the protective committee, Morris Plan Corporation succeeded in acquiring, by its exchange offer and to a minor degree by purchases, a total of 29,128 shares of the preferred stock, 71,251 shares of Class A common stock, and 1,000 shares of the Class

[254] Ibid.
[255] Ibid.

B stock of Atlantic and Pacific International Corporation.[256] These holdings constituted 67% of the outstanding preferred stock and 70% of the outstanding Class A stock of Atlantic and Pacific International Corporation.

Apparently, the truculent attitude of the protective committee of minority stockholders of Atlantic and Pacific International Corporation, coupled with the unfavorable attitude indicated in the opinion of Judge O'Dunne of the Baltimore Circuit Court to the scheme to amend the charter of Atlantic and Pacific International Corporation as a preliminary to the sale of Morris Plan Corporation securities to Atlantic and Pacific International Corporation caused its abandonment. Instead, Mr. Morris decided to reach Atlantic and Pacific International Corporation's cash by liquidating the company.[257] By the liquidation, Mr. Morris' company would obtain two-thirds of the assets of Atlantic and Pacific International Corporation by virtue of its holdings of two-thirds of the preferred stock of Atlantic and Pacific International Corporation.

Under Maryland law, to liquidate Atlantic and Pacific International Corporation would require the consent by two-thirds of each class of the corporation's voting stock, voting by classes.[258] Mr. Morris controlled two-thirds of the preferred stock and two-thirds of the Class A common stock of the Atlantic and Pacific International Corporation. However, the Gaevernitz group, through United States Shares Corporation, owned in excess of two-thirds of the Class B stock of the Atlantic and Pacific International Corporation. The Class B common stock would have been entitled to none of the assets of Atlantic and Pacific International Corporation if the company were liquidated. Nevertheless, the company could not be liquidated without the consent of the holders of the Class B stock, that is, the Gaevernitz group.

Mr. Morris broached the subject of liquidation of Atlantic and Pacific International Corporation to Mr. Gaevernitz. However, Mr. Gaevernitz proved no longer cooperative.[259] As the price of his consent to a liquidation, Mr. Gaevernitz demanded the purchase by Morris Plan Corporation of the frozen assets of both United States Shares Corporation and the Atlantic and Pacific International Corporation at a price which Mr. Morris considered exorbitant.[260] Mr. Morris testified:[261]

A. I thought everything was agreed and we went ahead with the offers and several weeks and months passed before we were ready to consummate the whole liquidation of Atlantic and Pacific, and then, to our utter amazement, Mr. Gaevernitz's whole attitude changed and instead of being cooperative and in accordance with the attitude of his early discussions—and I don't like to say that he assumed an attitude that would hold us up exactly, but his whole attitude changed and he commenced to lay down ultimatums as to what he would or what he would not do.

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[256] Id., Commission's Exhibit No. 733.
[257] Id., at 8126, 8135.
[258] Md. Code Ann. (Flack, 1935) Art. 23, § 88.
[259] Id., at 8134.
[260] Id., at 8127.
[261] Id., at 8126–7, 8133–5.

Q. And what he wanted?

A. Yes; and what he wanted.

Q. What did he want?

A. I don't remember, but he wanted two or three hundred thousand dollars for those "Eskimos," and I just told him he could go where the snowbirds couldn't live.

Q. Now, does this refresh your memory that they asked for approximately $560,000? Do you remember that figure?

A. I do not remember the figure you mention, but it is possible.

* * * * * * *

Q. Well, you said you had some difficulty with Mr. Gaevernitz about these negotiations.

A. Yes, sir.

Q. And you just didn't get control at that time of Atlantic and Pacific International Corporation?

A. We didn't get control so that we could liquidate it as we had contemplated.

Q. That is right; and then what did you do when you found yourself with the two-thirds of the preferred and two-thirds of the Class A stock of Atlantic and Pacific International Corporation and no cash?

A. Well, we found ourselves in the position of being substantial stockholders of Atlantic and Pacific International Corporation, when we had gone into it from the beginning with everybody cognizant of the purpose of expanding our capital resources, and we found it was just impossible to get anywhere with Mr. Gaevernitz.

Q. And why was that?

A. His conduct was somewhat like the old dog in the manger; we just couldn't get anywhere with him.

Q. He just didn't agree that you could take all the cash and he get none?

A. I didn't say that; that is your own inference.

Q. And what is your inference?

A. The dog in the manger tactics.

Q. And from your mention of the dog-in-the-manger attitude, it seems to me you want to create the impression that Mr. Gaevernitz wanted all the money.

A. I didn't say that.

Q. Well, did he want his share of it?

A. I didn't say that he wanted his share of it.

Q. What did you say?

A. I said we couldn't agree on the value of these frozen assets.

Q. Because of his "dog-in-the-manger" attitude?

A. Because I thought he was very stubborn about it and had assumed a contrary attitude to the original cooperation he seemed to have shown.

As he testified, Mr. Morris refused to assent to the demand of Mr. Gaevernitz. However, the Morris Plan Corporation was still in need of the cash assets held by Atlantic and Pacific International Corporation. Mr. Morris, therefore, placed the situation in the hands of his attorney, Ellery C. Huntington, of Satterlee & Canfield, for solution, on the ground that "Satterlee & Canfield had helped us to get into it and I wanted him to get us out of it the best way he could." [262] David M. Milton, then a partner in Satterlee & Canfield, testified that "Mr. Morris had squarely put it up to

[262] Id., at 8135.

the attorneys that they must find in some way some 'out' to the situation." [263]

Mr. Huntington in seeking a solution to the impasse between Mr. Morris and Mr. Gaevernitz sought the aid of his partner, David M. Milton. Mr. Milton saw in the situation a means of furthering the private investment plans of both Mr. Huntington and himself. During 1931, Mr. Milton and Mr. Huntington had become interested in acquiring control of American Colony Insurance Company and of Majestic Fire Insurance Company. Both of these companies had by 1932 largely reinsured their policy commitments and were actually functioning substantially as investment companies. Their securities, as was then the case with investment companies, were selling below asset value. During 1931 and 1932, Mr. Huntington, Mr. Milton, and their families had purchased 19,000 shares of the stock of American Colony Insurance Company [264] at a cost of approximately $175,000.[265]

The Atlantic and Pacific International Corporation situation presented to Mr. Milton an opportunity to use the funds of Atlantic and Pacific International Corporation to further his attempt to acquire control of American Colony Insurance Company and of Majestic Fire Insurance Company.

In order to accomplish both his own objective and the objectives of his client, Morris Plan Corporation, Mr. Milton caused Merton Assets Corporation to be organized in Canada in June 1932.[266] Merton Assets Corporation was a dummy corporation controlled by Mr. Milton and Mr. Huntington.[267]

Mr. Milton then negotiated with Mr. Gaevernitz and his associates for the purchase of their Class A stock of United States Shares Corporation.[268] This Class A stock, it will be recalled, represented 50% of the voting stock of United States Shares Corporation. United States Shares Corporation held 95% of the Class B stock of Atlantic and Pacific International Corporation. Both the Class A stock of United States Shares Corporation and the Class B stock of Atlantic and Pacific International Corporation had no asset value. As a result of these negotiations, Mr. Gaevernitz and his associates, in August 1932, agreed to sell their Class A stockholdings of United States Shares Corporation to Merton Assets Corporation for $335,935.[269] Though he had not yet paid the Gaevernitz group, Mr. Milton was put in control of Atlantic and Pacific International Corporation. Mr. Milton became the president of Atlantic and Pacific International Corporation.[270]

On August 12, 1932, Merton Assets Corporation agreed to purchase all of the Morris Plan Corporation's holdings of the securities of Atlantic and Pacific International Corporation for $1,145,000.[271]

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[263] Id., at 8101.
[264] Id., at 8065.
[265] Derived from supplementary information supplied the Commission for The Equity Corporation.
[266] Op. cit. supra, note 201, at 8103.
[267] Id., at 8104.
[268] Ibid.
[269] Id., at 8138.
[270] Id., at 8064.
[271] Id., at 8136 and Commission's Exhibit No. 733.

This price was equivalent to approximately $40 per share for the Morris Plan Corporation holdings of preferred stock of Atlantic and Pacific International Corporation and represented its then liquidating value, on the basis of the quick assets of Atlantic and Pacific International Corporation.[272]

To obtain the funds to make these payments, Merton Assets Corporation, then controlled by Mr. Milton, borrowed $1,480,935 from Atlantic and Pacific International Corporation, also controlled by Mr. Milton.[273]

The funds so obtained by Merton Assets Corporation were used to pay the Morris Plan Corporation for its holdings of Atlantic and Pacific International Corporation securities and the Gaevernitz group for its holdings of the Class A shares of United States Shares Corporation which owned 95% of the Class B stock of Atlantic and Pacific International Corporation.[274]

Thus, without the expenditure of any of his own funds and by the simple expedient of using the funds of Atlantic and Pacific International Corporation, Mr. Milton acquired control of that corporation.[275] In doing so he had accomplished what he described as a "liquidation"[276] of Atlantic and Pacific International Corporation. The "liquidation," however, was accomplished in derogation of the priorities of the security holders of Atlantic and Pacific International Corporation. The Gaevernitz group, which controlled through United States Shares Corporation the Class B shares of Atlantic and Pacific International Corporation, received from the assets of Atlantic and Pacific International Corporation $335,000. This represented, in effect, a payment for the Class B shares which on a statutory liquidation of the corporation would have been entitled to none of the corporate assets.

The minority stockholders of Atlantic and Pacific International Corporation were unaware of this "liquidation" of their corporation and of the method by which Mr. Milton had obtained control of their corporation. In fact, Mr. Milton testified that the entire transaction was of his own making. He testified that Morris Plan Corporation and the Gaevernitz group were not participants in the transaction and that they were in fact unaware of the method by which Merton Assets Corporation had obtained the funds to pay for their shares.[277] Mr. Milton, when examined on this entire transaction, testified:[278]

Q. You say that Merton Assets was organized when, in August?

A. The end of the summer.

Q. Of 1932, isn't that so?

A. Yes.

Q. Then there was a deal made between Gaevernitz and Hardenbrook * * * who controls the "B" stock and the Morris Plan whereby Hardenbrook-

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[272] Id., at 8136 and Commission's Exhibit No. 737.

[273] Id., at 8106.

[274] Id., at 8138.

[275] Id., at 8064 and 8065. Mr. Huntington testified (id., at 8065):

> Q. Now Mr. Milton and the members of the board at that time didn't have a nickel invested in United States Shares Corporation or in Atlantic and Pacific International Corporation, did they?
> A. I think that is correct.

[276] Id., at 8103, et seq.

[277] Id., at 8115.

[278] Id., at 8103–4, 8106–8, 8115.

Gaevernitz transferred their stock to the Merton Assets Corporation and the Morris Plan transferred its stock.

A. Simultaneously.

Q. That put Merton Assets Corporation in control of the Atlantic and Pacific International Corporation with respect to every class of stock, isn't that so?

A. I think that is correct.

Q. As soon as the stock was transferred to Merton Assets, and by the way, what did Merton Assets have?

A. Just a corporation for the purpose, and I don't remember the details, but the money for the purchase was taken, of course, from the Atlantic and Pacific group.

Q. So that you had this stock in Merton Assets and then?

A. It could have been done directly, but it was done in this way.

Q. So that the form it took they transferred the stock to the Merton Assets, and then the money to buy that stock from Meron Assets came from Atlantic and Pacific International Corporation, $1,500,000, isn't that so?

A. You have got the figures and I don't remember but whatever was necessary.

Q. $1,500,000.

A. In other words, it was intended as a liquidating operation.

* * * * * * *

Q. Instead of Morris and Gaevernitz, after this court decision [the opinion of Judge O'Dunne of Maryland Circuit Court] turning their stock in directly, and taking out $1,500,000, they first formed a corporation up in Canada and Merton Assets——

A. Let me be clear on this thing. I don't know whether they knew anything about it.

Q. Who did it?

A. I did it.

Q. You went down and took $1,500,000 from A. & P.?

A. I was trying to work out the consolidation.

Q. But you took it out?

A. That is right.

Q. And at the time you took it out, you turned over nothing to A. & P.

A. But the stock was held.

Q. The stock was still up in Canada.

A. I don't know the details, but that was the effect of it.

Q. And what Atlantic and Pacific International Corporation had was really an account receivable, isn't that so?

A. It had the right to this stock.

Q. But the stock wasn't turned over at that time?

A. No.

* * * * * * *

Q. In retrospect, what do you think of the entire deal?

A. I don't know why I ever went into a transaction of this kind to work out a situation of this kind; we couldn't find any other way to do it, to liquidate this company, and took this form, and I can't answer why, and it could have been done just as well directly.

* * * * * * *

Q. I don't think that I am exaggerating, and I know precisely how you feel about the whole transaction. It is not very pleasant for me to interrogate you about it. I feel that I know what your present state of mind is upon that particular transaction, and as far as I am concerned, I am personally satisfied.

But can I say it this way, this transaction isn't one of the things that you are proud of?

A. I should say not.

* * * * * * *

Q. What you call "liquidation" was to get the one million one hundred and forty-five thousand dollars for Mr. Morris?

A. The whole thing was a liquidation.

Q. Because Mr. Morris could not accomplish his original purpose of trying to get control of this company and sell them $1,950,000 of the stock, isn't that so?

A. I think it is only fair to Mr. Morris to say that I would take full responsibility for doing this thing. To what extent he knew it was being liquidated in this manner, I do not know. I think he did not interest himself in these details.

Q. Yes.

A. I don't think he knew very much about it. It was left to myself and my attorney.

Mr. Milton's method of liquidating Atlantic and Pacific International Corporation constituted a substantial achievement of the purpose of his client, Morris Plan Corporation, to acquire the cash assets of Atlantic and Pacific International Corporation, Mr. Morris testified: [279]

A. * * * After I turned this matter over to Mr. Huntington and agreed to accept the figure referred to in the exhibit you have just introduced, and was assured that that figure would be payable on some kind of a, I think, draft attached to the stock, we were no longer interested in the subject matter, had nothing further to do with it, and I do not know to this day what became of the Atlantic & Pacific.

Q. Well you ought to have a pretty good idea, Mr. Morris, you took out of the corporation $1,145,000 which was virtually all the cash it had, wasn't it?

A. I refer to my answer.

Q. All right, the fact of the matter is that you did accomplish your purpose, didn't you?

A. No, sir.

Q. Why not? You exchanged the Morris Plan stock for Atlantic and Pacific International preferred and then somebody bought your Atlantic and Pacific International preferred, and you wound up with cash.

A. We partly accomplished it.

Q. And you wound up with the sum of $1,145,000.

A. And to the extent of the cash received—to that extent we accomplished our purpose.

In addition to accomplishing the objective of the Morris Plan Corporation, his client, Mr. Milton, had acquired control of Atlantic and Pacific International Corporation without the expenditure of any of his own funds.[280] Following the loan to Merton Assets Corporation, Atlantic and Pacific International Corporation had in its treasury quick assets worth only $350,000.[281] These funds were available to the Milton-Huntington interests to further their plan to ac-

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[279] Id., at 8136–7.

[280] See supra, p. 1131.

[281] Op. cit. supra, note 201, at 8110.

quire control of American Colony Insurance Company and of Majestic Fire Insurance Company. Mr. Milton testified: [282]

A. From a practical point of view, the purchase of the Morris Plan stock, and the other stock it could have been done directly and, exchanged the stock I don't think that I would have undertaken it entirely for the purpose of breaking a deadlock between a controlling faction and a preferred faction and go through the process * * *.

Q. Yes.

A. And go through the process of doing this [the Merton Assets Corporation transaction] if it had been for the fact that for a period, for a considerable period prior to this, I had had negotiations and made a study of these fire insurance situations, and as I stated it before, it became obvious that by accumulating some of these fire insurance stocks, at discount values and putting them together, not only would you get complete value, but a premium value therefor * * *.

To accomplish this plan to use, for the purchase of additional stock of the insurance companies in which Mr. Milton and Mr. Huntington were interested, the $350,000 of quick assets which remained in Atlantic and Pacific International Corporation after the Merton Assets Corporation transaction, the Milton-Huntington interests caused Underwriters Equities, Inc. to be formed on November 23, 1932.[283] This corporation had two classes of stock, denominated Class A and Class B which were alike except that the Class B stock as a class at all times was to have 50% of the entire voting power.[284] In other words, the Class B stockholders controlled the management of the corporation. The Milton-Huntington interests turned over to Underwriters Equities, Inc. their holdings of 19,000 shares of American Colony Insurance Company in return for 38,000 shares of the Class B stock of Underwriters Equities, Inc.[285] Atlantic and Pacific International Corporation invested $95,000 in a block of the Class A stock of Underwriters Equities, Inc.,[286] and these funds were utilized by Underwriters Equities, Inc. to acquire 8,023 additional shares of the stock of American Colony Insurance Company,[287] an amount of stock which, coupled with the 19,000 shares of this insurance company's stock already held by Underwriters Equities, Inc., was sufficient to give Underwriters Equities, Inc., control of that insurance company.

Meanwhile, Atlantic and Pacific International Corporation under the control of Milton had purchased 25,693 shares of the stock of Majestic Fire Insurance Company at a cost of $135,000.[288] This block of stock represented a controlling interest in Majestic Fire Insurance Company.[289] The Majestic Fire Insurance Company stock held by Atlantic and Pacific International Corporation was, on or soon after the formation of Underwriters Equities, Inc., turned

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[282] Id., at 8111–2.

[283] *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2698; op. cit. supra, note 201, at 8063.

[284] Id., at 2699.

[285] Id., at 7873.

[286] Id., at 8061.

[287] Id., at 8062, 8532.

[288] Id., at 8063.

[289] *Moody's Manual of Investments, Banks, etc.*, 1932, p. 1522. There were 50,000 shares outstanding with a $5 par value (ibid.).

over to Underwriters Equities, Inc., in exchange for an additional block of the Class A stock of that corporation.[290]

In January 1933, the Milton-Huntington interests delivered their 38,000 shares of the Class B stock of Underwriters Equities, Inc., and $41,000 in cash to Consolidated Funds Corporation of New York, a company formed in 1926 in which Milton had previously had a minority interest,[291] in return for 42,630 shares of the common stock of Consolidated Funds Corporation of New York. This stock put the Milton-Huntington interests in control of Consolidated Funds Corporation.

Underwriters Equities, Inc., as has been related, had acquired, largely with the funds of Atlantic and Pacific International Corporation, control of American Colony Insurance Company and of Majestic Fire Insurance Company. This control placed Underwriters Equities, Inc., in a position to make exchange offers for further shares of the stock of these insurance companies.[292] Exchange offers by Underwriters Equities, Inc., increased its holdings of the stocks of these insurance companies.[293] Underwriters Equities, Inc., also caused the merger of Majestic Fire Insurance Company with Colonial States Fire Insurance Company.[294] The new company, called Colonial States Insurance Company, was controlled by Underwriters Equities, Inc.

In May 1933, Underwriters Equities, Inc., sold to Interstate Equities Corporation, then a subsidiary of The Equity Corporation, its holdings of American Colony Insurance Company and Colonial States Insurance Company for $893,984.[295] These funds were, as has already been described,[296] used by the Milton-Huntington interests to purchase from Wallace Groves his controlling block of the common stock of The Equity Corporation. Thus, the use of the funds of Atlantic and Pacific International Corporation was one of the substantial means by which the Milton-Huntington interests acquired control of The Equity Corporation.

To return to Atlantic and Pacific International Corporation, by the close of 1932 that corporation's assets consisted of an unsecured account receivable from Merton Assets Corporation in the sum of $1,480,935 and a block of the Class A stock of Underwriters Equities, Inc., which it had acquired at a cost of approximately $230,000. The Merton Assets Corporation loan was in effect a claim only against Atlantic and Pacific International Corporation's own securities which constituted virtually the sole asset of Merton Assets Corporation. In effect, therefore, substantially all of Atlantic and Pacific International Corporation's "general funds"[297] were invested in the class A

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[290] *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2430; op. cit. supra, note 201, at 8003.

[291] *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2678; op. cit. supra, note 201, at 7872, 7873, 8113.

[292] *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2698.

[293] By February 28, 1938, Underwriters Equities, Inc., owned 41,734 shares of American Colony Insurance Company and 35,780 shares of Majestic Fire Insurance Company of New York (*Moody's Manual of Investments, Banks, etc.*, 1933, p. 2699).

[294] Op. cit. supra, note 201, at 8534 and Commission's Exhibits Nos. 837 and 840.

[295] See supra, pp. 1042–3.

[296] Ibid.

[297] Op. cit. supra, note 201, Commission's Exhibit No. 729.

stock of Underwriters Equities, Inc. Thus, the charter of Atlantic and Pacific International Corporation, which forbade investment of more than 25% of the corporation's "general funds" in the securities of investment organizations,[298] may have been violated by the Milton-Huntington interests. Minority stockholders of Atlantic and Pacific International Corporation were unaware of this change in the investment policy of their company from one of investment primarily in government securities to one of investment in insurance companies through Underwriters Equities, Inc.

In an effort to eliminate the minority stock interests in Atlantic and Pacific International Corporation, Mr. Milton conducted negotiaations [299] with the protective committee of Philadelphia bankers who had, it will be remembered, successfully frustrated the Morris Plan Corporation's original plans to sell its own securities to Atlantic and Pacific International Corporation. Mr. Milton informed the protective committee of the plan of Consolidated Funds Corporation of New York and of its subsidiary, Underwriters Equities, Inc., to acquire control of American Colony Insurance Company and of Majestic Fire Insurance Company.[300] The record does not indicate, however, that Mr. Milton informed the protective committee of the methods by which he had obtained control of Atlantic and Pacific International Corporation or of the fact that the use of that corporation's funds had enabled Underwriters Equities, Inc., to acquire control of the insurance companies.

As a result of these negotiations, the protective committee agreed to recommend to the Atlantic and Pacific International Corporation preferred stockholders, which it represented, the acceptance of an offer of Consolidated Funds Corporation of New York to exchange its preferred and Class A stock for the preferred and Class A stock of Atlantic and Pacific International Corporation.[301] On January 10, 1933, Consolidated Funds Corporation made its offer [302] which was accepted by virtually all of the Atlantic and Pacific International Corporation stockholders represented by the protective committee. The Consolidated Funds Corporation exchange ultimately proved to be more beneficial to the preferred stockholders of Atlantic and Pacific International Corporation who accepted it than was the Morris Plan Corporation offer. As at December 18, 1936, the Consolidated Funds Corporation securities, which were received in exchange for Atlantic and Pacific International Corporation preferred stock, had a market value of $53. In contrast, the Morris Plan Corporation securities which were received in exchange for Atlantic and Pacific International Corporation preferred stock then had a market value of $21.[303]

Having eliminated the possibility of opposition from the protective committee of Atlantic and Pacific International Corporation stockholders, Mr. Milton, on May 31, 1933, caused the certificate of incorporation of Atlantic and Pacific International Corporation to be

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[298] Ibid.

[299] Id., at 8095.

[300] Derived from supplementary information supplied the Commission for The Equity Corporation.

[301] Op. cit. supra, note 201, at 8097.

[302] Id., Commission's Exhibit No. 732.

[303] Id., at 8156.

amended so as to eliminate all of the previous restrictions upon its investment policies.[304]

Following the exchange offer of Consolidated Funds Corporation, a small minority interest in Atlantic and Pacific International Corporation was still held by the public. Mr. Milton was also pressed by the necessity of removing the indebtedness of Merton Assets Corporation to Atlantic and Pacific International Corporation. To eliminate this indebtedness and to decrease the minority interest in Atlantic and Pacific International Corporation, a plan was devised to offer the stock of Underwriters Equities, Inc., in the portfolio of Atlantic and Pacific International Corporation in exchange for Atlantic and Pacific International Corporation's own preferred stock in the ratio of 10 shares of Underwriters Equities, Inc., for each outstanding share of Atlantic and Pacific International Corporation's preferred stock.[305] As Mr. Milton testified:[306]

> * * * The investments you talk about were made in these insurance stocks with monies of Atlantic and Pacific, and later as you have shown those insurance stocks were turned in for Underwriters Equities. That Underwriters Equities [stock] at that point found itself in the till of the Atlantic and Pacific International Corporation and that was offered to all the preferred stockholders and I believe that that was an offer subsequent to the offer you have just described of Consolidated Funds, by which Consolidated Funds gathered together a substantial block of preferred stock.

Atlantic and Pacific International Corporation, still under the control of Merton Assets Corporation, thereupon exchanged its holdings of Underwriters Equities, Inc., for its own preferred stock held by Merton Assets Corporation in the ratio of 10 shares of Underwriters Equities, Inc., stock for one share of its own preferred stock. Then Atlantic and Pacific International Corporation bought back from Merton Assets Corporation the Underwriters Equities, Inc., stock which it had exchanged for its own preferred stock. The price necessary for such purchase was credited to the account receivable of $1,480,935 due from Merton Assets Corporation on Atlantic and Pacific International Corporation's books. The exchange and repurchase of Underwriters Equities, Inc., stock was repeated several times until the entire account receivable was eliminated.[307]

At the conclusion of these exchanges, Atlantic and Pacific International Corporation owned substantially all of its original holdings of the Class A stock of Underwriters Equities, Inc., and had retired all but approximately 3,000 shares of its preferred stock.[308] In addition, the indebtedness of Merton Assets Corporation to Atlantic and Pacific International Corporation had been eliminated.

On January 8, 1936, Atlantic and Pacific International Corporation was liquidated.[309] Its assets were sufficient to pay the full liquidating value for each share of its outstanding 3,082 shares of

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[304] Id., Commission's Exhibit No. 739.

[305] Id., at 8113.

[306] Ibid.

[307] Derived from supplementary information supplied the Commission for The Equity Corporation.

[308] *Moody's Manual of Investments, Banks, etc.*, 1935, p. 1030.

[309] *Poor's Banks, etc.*, 1936, p. 2646.

preferred stock and $157,252 of dividend arrearages on such stock, and $1.90 for each share of its outstanding $100{,}937\frac{64}{80}$ shares of Class A stock.[310]

Thus, the tactics employed by Mr. Milton to obtain control of and to appropriate the funds of Atlantic and Pacific International Corporation in a manner satisfactory to his client, Morris Plan Corporation, and to his own interests, "fortunately worked out," without great loss to the investment company's minority stockholders, who did not accept the Morris Plan Corporation's exchange offer. Mr. Milton testified:[311]

A. * * * In other words, I want to be sure I am clear that when you say "justified" I wanted to have it work out, but I don't think it was a good way to do it, and it should not be done that way again.

Q. * * * Mr. Morris found himself, if you will permit me to use a very crude expression, in a pickle, and somebody had to get him out of it, and he called on you to do that.

A. Well, he called on me, or rather on Mr. Huntington to find some way out, and Mr. Huntington called on me and we went in and did the job and, fortunately, it worked out the way it did.

Q. It worked out?

A. Yes. I put my neck out and did the job.

Q. And you certainly did put it out, Mr. Milton.

A. It was put out plenty.

c. United Founders Corporation—The Equity Corporation

In June 1933, The Equity Corporation became interested in acquiring control of United Founders Corporation and its subsidiaries. The control of United Founders Corporation was, at this time, in the hands of the three men who had organized the trust, Louis H. Seagrave, Christopher F. Coombs, and Frank B. Erwin.[312] These men held equal thirds of the 1,000,000 shares of Class A stock of United Founders Corporation then outstanding.[313]

The certificate of incorporation of United Founders Corporation specifically accorded the 1,000,000 shares of Class A stock a voting power equal at all times to one-half the voting power of the total outstanding common, regardless of the amount of common stock outstanding.[314] Thus, the Class A stock, in June 1933, had voting power equal to 4,500,000 shares of common stock, since 9,000,000 shares of common stock were then outstanding.[315] The certificate of incorporation of United Founders Corporation further provided that the Class A stock was to share in the distribution of the corporate earnings or surplus and in the distribution of the corporate assets upon dissolution or liquidation of the corporation in the proportion that "the amount * * * contributed to the capital and/or paid-in surplus of the corporation by the holders of the Class A stock bears to the entire amount * * * contributed to the capital and/or

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[310] Ibid., and op. cit. supra, note 201, at 8115–6.
[311] Id., at 8116.
[312] Id., at 8546 and Commission's Exhibit No. 745.
[313] Id., Commission's Exhibits Nos. 751, 752.
[314] Id., Commission's Exhibit No. 745.
[315] Id., Commission's Exhibit No. 764.

surplus of the corporation by the holders of all the shares of both Class A or common stock." [316]

By 1933, the common stock had contributed to the corporation capital of about $297,000,000,[317] whereas the million shares of Class A had at the inception of the corporation been issued to the sponsors, Messrs. Seagrave, Coombs, and Erwin in exchange for American Founders Corporation stock of a market value, in February 1929, of only $1,000,000.[318]

By June 1933, after tremendous losses, the net assets of the United Founders Corporation had decreased to approximately $15,000,000.[319] The asset value of the Class A stock was thus, by virtue of the provisions of the certificate, equal to $1/298$ of the total asset value, or approximately $48,000,[320] and the asset value per share of the Class A stock was approximately 5 cents. Nevertheless, as Mr. Seagrave admitted in his testimony,[321] the Class A stock still retained 33⅓% of the total voting power of United Founders Corporation, control of which The Equity Corporation wished to secure.

The Equity Corporation proceeded, in June 1933, to obtain control of the United Founders Corporation by purchasing from Mr. Coombs and Mr. Erwin their 666,666⅔ shares of Class A stock. The purchase of Class A stock from Mr. Coombs and Mr. Erwin was consummated as part of a transaction by which Mr. Coombs and Mr. Erwin transferred to The Equity Corporation their Class A stock and 635,000 shares of United Founders Corporation common stock and received in exchange $954,000 in cash and 260,150 shares of The Equity Corporation common stock.[322]

Since The Equity Corporation made a "basket purchase" of both the Class A stock and the common stock from Mr. Coombs and Mr. Erwin, the amount of the premium paid by The Equity Corporation for the Class A stock cannot be isolated with exactness. However, the testimony at the public examination discloses that the asset value of the 260,150 shares of The Equity Corporation common stock received by Mr. Coombs and Mr. Erwin [323] more than balanced the asset value of the 635,000 shares of United Founders Corporation common stock transferred to The Equity Corporation by Mr. Coombs and Mr. Erwin.

In May 1935, The Equity Corporation made an offer to United Founders Corporation common stockholders to exchange three-tenths of one share of The Equity Corporation common stock for each share of United Founders Corporation common stock. This exchange offer, in May 1935, may be an indication of the comparative exchange values of the United Founders Corporation and The Equity Corporation common stock in 1933, inasmuch as United Founders Corporation common stock did not appreciate in asset value from 1933 to 1935.[324]

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[316] Id., Commission's Exhibit No. 745.
[317] Id., Commission's Exhibit No. 764.
[318] Id., Commission's Exhibits Nos. 751, 752.
[319] Id., Commission's Exhibit No. 797.
[320] Ibid.
[321] Id., at 8578.
[322] Id., at 8637–8.
[323] The market value of The Equity Corporation common stock received by the founders of United Founders Corporation was approximately $1,474,579 (id., at 8638).
[324] Id., at 8666 and Commission's Exhibit No. 839.

On the United Founders Corporation common stock, based on The Equity Corporation common stock exchange, the 635,000 shares of United Founders Corporation common stock would have yielded Mr. Coombs and Mr. Erwin only 190,500 shares of The Equity Corporation common stock. Since Mr. Coombs and Mr. Erwin received a greater number of shares of The Equity Corporation common stock in the transaction than they would have received for their United Founders Corporation common stock on the regular exchange basis, it is clear that the entire cash payment of $954,000 constituted a premium to Mr. Coombs and Mr. Erwin on the Class A stock. Moreover, the excess of The Equity Corporation stock constituted a further premium to Mr. Coombs and Mr. Erwin of about $130,000 logically attributable to the Class A stock transfer rather than to the United Founders Corporation common stock transfer. David M. Milton, the president of The Equity Corporation, testified:[325]

Q. So that the ultimate result is Mr. Coombs and Mr. Erwin through their foreign corporations, for their 666,666 shares of their Class A and 635,000 shares of United Founders Corporation common stock received, if we put it in round numbers, approximately a million dollars in cash and 260,150 shares of Equity common. Isn't that so?

A. $945,000.

Q. $954,000, if you want to be exact.

A. That is approximately it.

* * * * * * *

Q. What was the market value of the Equity common on June 4, 1934, approximately?

A. About one and seven-eighths to two.

* * * * * * *

Q. On the basis of that market value they got approximately $1,474,579 for that stock?

A. I think that is right, approximately.

It should be recalled that the Class A stock was originally acquired by Messrs. Seagrave, Coombs, and Erwin in return for securities of a market value of approximately $1,000,000, and that the asset value of the entire outstanding Class A common stock had dwindled from $1,000,000 to $48,000. For two-thirds of this stock having an asset value of $32,000, The Equity Corporation, in order to acquire control of United Founders Corporation, paid more than $1,000,000 to Mr. Coombs and Mr. Erwin.

In addition to the premium paid to Mr. Coombs and Mr. Erwin for the transfer of their two-thirds of the Class A stock, The Equity Corporation paid an additional sum to Mr. Seagrave, the holder of the other third of the Class A stock of United Founders Corporation for the privilege of being permitted by him to purchase the Class A stock from Mr. Coombs and Mr. Erwin. At the time of the issuance of 1,000,000 shares of the Class A stock in equal thirds to the three sponsors, Messrs. Seagrave, Coombs, and Erwin, they had contracted with each other that the Class A stock would be voted as a unit, and that none of the three would sell any part of his Class A stock without the written consent of the others.[326] To clear the way to negotiations for the purchase of the Class A stock held by Mr. Coombs and

[325] Id., at 8637–8.

[326] Id., Commission's Exhibit No. 746.

Mr. Erwin. The Equity Corporation procured from Mr. Seagrave an assignment by which the latter relinquished his rights to prevent Mr. Coombs and Mr. Erwin from selling their stock to The Equity Corporation.[327] Mr. Seagrave did not sell his own holdings of the Class A stock but merely relinquished his contractual power to impede The Equity Corporation's purchase from Mr. Coombs and Mr. Erwin. As consideration, Mr. Seagrave received from The Equity Corporation $40,000 in cash and 70,000 shares of United Founders Corporation common stock which had a market value at the time of $1 a share.[328]

The working control of United Founders Corporation, obtained by The Equity Corporation by the payment of the premium for the Class A stock, was a pivotal point in The Equity Corporation's expansion program. In June 1933, United Founders Corporation controlled American Founders Corporation by holding 78.7% of the latter's voting stock. American Founders Corporation, in turn, held control of five investment trusts, namely: International Securities Corporation of America, Second International Securities Corporation, United States & British International Company, Ltd., American & General Securities Corporation, and American and Continental Corporation.[329] The total consolidated assets of these companies at the time The Equity Corporation acquired the Class A stock of United Founders Corporation, was between $45,000,000 and $50,000,000.[330]

Mr. Milton testified that the purpose of The Equity Corporation in acquiring control of United Founders Corporation by means of the transaction with Mr. Coombs and Mr. Erwin was to acquire further shares in the "Founders" system of companies by purchase and exchange offers and eventually to merge or consolidate the various component companies which were subsidiaries of United Founders Corporation.[331]

The control of the management of United Founders Corporation represented by the Class A stock enabled The Equity Corporation, with at least the passive acquiescence of the prior managers, to carry through its program of exchange offers.[332] From June 1933 to No-

[327] Id., at 8584.

[328] Id., at 8587.

[329] In terms of percentages of the total outstanding, the holdings of American Founders Corporation in the common stock of these companies were as follows (id., Commission's Exhibit No. 843):

	Approximate percent
International Securities Corporation of America:	
Class A common	94
Class B common	96
Second International Securities Corporation:	
Class A common	95
Class B common	97
United States & British International Company, Ltd.:	
Class A common	96
Class B common	89
American & General Securities Corporation:	
Class A common	97
Class B common	96
American and Continental Corporation:	
Class A	50
Common stock	53

[330] Id., at 8276.

[331] Id., at 8603–4.

[332] Mr. Seagrave continued as a director and officer of United Founders Corporation and of American Founders Corporation until November 1935, when these and other companies were consolidated to form American General Corporation (id., at 8299). On the formation of American General Corporation, Mr. Seagrave became the chairman of the board of directors of that company (id., at 8218). For a discussion of the consolidation of United

vember 1933, The Equity Corporation made seven exchange offers to the stockholders of United Founders Corporation, American Founders Corporation, and American and Continental Corporation.[333] Stockholders who accepted these offers suffered substantial losses in asset values.[334]

In November 1935 The Equity Corporation caused all of the companies in the United Founders Corporation system of corporations to be consolidated into American General Corporation.[335]

d. Chatham Phenix Allied Corporation—Atlas Corporation

Chatham Phenix Allied Corporation was incorporated in Delaware on September 28, 1929,[336] by Chatham Phenix Corporation, an affiliate of the Chatham Phenix National Bank & Trust Company, a New York City commercial bank.[337] The stock of the affiliate was held in a voting trust of which the trustees were Louis G. Kaufman, Samuel McRoberts, Ellis P. Earle, Haley Fiske, and Richard H. Higgins,[338] all of whom were direcors of Chatham Phenix National Bank & Trust Company,[339] so that the directorate of the bank also controlled the Chatham Phenix Corporation. All of the directors of Chatham Phenix Corporation were directors of the bank, and upon the organization of the Chatham Phenix Allied Corporation, all of the directors of the bank became directors of Chatham Phenix Allied Corporation.[340] Samuel McRoberts became president of the Chatham Phenix

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Founders Corporation and its subsidiaries to form American General Corporation see infra, pp. 1485–99.

333 Id., Commission's Exhibit No. 839.

334 For example, the preferred stockholders of American Founders Corporation who accepted the offers of The Equity Corporation suffered losses in asset value of $1,484,145 (Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pt. VII, p. 208, note 27).

335 For a discussion of this consolidation see infra, pp. 1485–99.

336 Public Examination, Chatham Phenix Allied Corporation, Commission's Exhibit No. 1588. For a more detailed discussion of the history of Chatham Phenix Allied Corporation, see Ch. II of this part of the report, pp. 123–42.

337 Public Examination, Chatham Phenix Allied Corporation, at 15424.

338 Id., at 15419.

339 *Moody's Manual of Investments, Banks, etc.*, 1929, p. 254.

340 The following table illustrates the interlocking directorates of the bank, the security affiliate, and the investment company (op. cit. supra, note 337, Commission's Exhibit No. 1589; and *Moody's Manual of Investments, Banks, etc.*, 1930, pp. 164, 165, and 2250):

Bank (32 directors)	Security affiliate (9 directors)	Investment company (16 directors)
1. Samuel McRoberts	Samuel McRoberts	Samuel McRoberts.
2. (*)	Rollin C. Bortle	Rollin C. Bortle.
3. William B. Joyce	William B. Joyce	William B. Joyce.
4. Richard H. Higgins	Richard H. Higgins	Richard H. Higgins.
5. Louis G. Kaufman	Louis G. Kaufman	Louis G. Kaufman.
6. Ellis P. Earle	Ellis P. Earle	Ellis P. Earle.
7. J. Frederich Talcott	J. Frederich Talcott	J. Frederich Talcott.
8. S. B. Thorne	S. B. Thorne	S. B. Thorne.
9. Edgar S. Bloom	Edgar S. Bloom	Edgar S. Bloom.
10. Harold I. Pratt		Harold I. Pratt.
11. Edward F. Hutton		Edward F. Hutton.
12. Frank Phillips		Frank Phillips.
13. George MacDonald		George MacDonald.
14. Eugene E. du Pont		Eugene E. du Pont.
15. Fred M. Kirby		Fred M. Kirby.
16. Van Lear Black		Van Lear Black.

* Rollin C. Bortle, although not a director of the bank, was a vice president.

Allied Corporation.[341] In addition, as will be related, Chatham Phenix Corporation acquired all of the voting stock of Chatham Phenix Allied Corporation. The interrelationship of the bank and the investment company, Chatham Phenix Allied Corporation, was, as will be indicated, one of the motivating factors which resulted in the passage of control of Chatham Phenix Allied Corporation to Atlas Corporation.

The authorized capitalization of Chatham Phenix Allied Corporation consisted of 3,000,000 shares of capital stock, all without par value and all entitled to the same rights and privileges with the notable exception that only 100,000 shares of the corporation's stock were to have voting power.[342] On September 30, 1929, Chatham Phenix Corporation firmly committed itself to purchase the 100,000 shares of voting stock and 1,900,000 shares of nonvoting stock of Chatham Phenix Allied Corporation at a price of $25 a share, to net the corporation $50,000,000.[343] Delivery and payment for the shares was to occur concurrently on October 8, 1929.[344]

The 100,000 shares of voting stock, constituting all of the voting stock of the corporation, was to be retained by Chatham Phenix Corporation. The prospectus offering the nonvoting stock revealed the fact that Chatham Phenix Corporation was to acquire all of the voting stock as an "investment."[345] Thus, on an investment of $2,500,000, Chatham Phenix Corporation acquired sole and absolute control of $47,500,000 of the public's funds. In addition, Chatham Phenix Corporation derived approximately $2,245,000 in selling commissions and trading profits incident to the public offering of the nonvoting shares.[346] Thus, the net cost to Chatham Phenix Corporation of the 100,000 shares of voting stock may be considered not to have exceeded $5,000. Mr. McRoberts described the control of Chatham Phenix Allied Corporation by Chatham Phenix Corporation as the "strength" of the public offering, and testified to his belief that the public which subscribed to the nonvoting stock relied on the fact of control and management of Chatham Phenix Allied Corporation by Chatham Phenix Corporation and Chatham Phenix National Bank & Trust Company.[347] Nevertheless, despite this reliance by stockholders on the continuance of management of the Chatham Phenix Allied Corporation by the Chatham Phenix Corporation, that corporation, as will be seen, transferred control and management of the corporation to Atlas Corporation in August 1931 without the previous consent of the stockholders of Chatham Phenix Allied Corporation.[348]

Late in September 1929, Chatham Phenix Corporation and a selling group of dealers offered to the public at a price of $27 a share the 1,900,000 shares of the nonvoting stock.

On October 8, 1929, the date on which Chatham Phenix Allied Corporation was to receive $50,000,000 in payment for the 100,000

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341 Ibid.

342 Op. cit. supra. note 337, Commission's Exhibit No. 1588.

343 Id., at 15426–7.

344 Id., at 15433 and Commission's Exhibit No. 1590.

345 Id., Commission's Exhibit No. 1589.

346 Id., at 15564.

347 Id., at 15429.

348 Id., at 15430 and Commission's Exhibit No. 1617.

shares of its voting stock and the 1,900,000 shares of its nonvoting stock, Chatham Phenix Corporation actually had on deposit with Chatham Phenix National Bank & Trust Company only $3,892,995.[349] Nevertheless, on October 8, 1929, Chatham Phenix Corporation drew and delivered a check in the sum of $50,000,000 drawn on Chatham Phenix National Bank & Trust Company, to the order of Chatham Phenix Allied Corporation.[350] On October 9, 1929, deposits by the Chatham Phenix Corporation at the bank had increased to $32,341,600.[351] However, on that date the bank honored the check payable to Chatham Phenix Allied Corporation drawn by Chatham Phenix Corporation in the sum of $50,000,000. The overdraft of $18,000,000 was eliminated by an unsecured loan by Chatham Phenix Allied Corporation to Chatham Phenix Corporation in the sum of $18,000,000 which the latter corporation deposited in its account at the bank.[352] As a net result of these transactions in which the bank participated, Chatham Phenix Allied Corporation actually received only $32,000,000 in cash and the unsecured promise of Chatham Phenix Corporation to pay to it $18,000,000.

By October 14, 1929, Chatham Phenix Corporation had repaid $11,000,000 of its $18,000,000 indebtedness to Chatham Phenix Allied Corporation, leaving a balance due of $7,000,000.[353] Thereafter, Chatham Phenix Corporation reborrowed on collateral security further sums from Chatham Phenix Allied Corporation.[354] Virtually an open account existed between the two corporations.[355] By December 31, 1929, the account owed Chatham Phenix Allied Corporation by Chatham Phenix Corporation was $15,700,000.[356] At August 17, 1931, the date that control of the investment company was acquired by Atlas Corporation, the amount due from Chatham Phenix Corporation to Chatham Phenix Allied Corporation was $10,556,993.73.[357] The method by which this sum was repaid will be described later.

Following the collapse in value of securities after 1929, Chatham Phenix Allied Corporation conducted extensive trading operations in its nonvoting capital stock held by the public. As Louis G. Kaufman, the president of the Chatham Phenix National Bank & Trust Company and a director of the Chatham Phenix Allied Corporation, conceded, obviously a decline in the market price of the stock of an investment company associated with a bank would reflect on the prestige and financial stability of the bank.[358] Indirectly, therefore, the trading operations by Chatham Phenix Allied Corporation in its own stock redounded to the benefit of its bank sponsor. Such trading operations also tended to create a market for the shares of the investment company's nonvoting stock held by the public. From January 3, 1930, to August 11, 1931, Chatham Phenix Allied Corporation repurchased 565,564 shares of its own nonvoting stock at a cost

[349] Id., Commission's Exhibit No. 1593.
[350] Id., Commission's Exhibit No. 1592.
[351] Id., at 15556, 15437–8 and Commission's Exhibit No. 1593.
[352] Id., at 15445–7.
[353] Id., Commission's Exhibit No. 1596.
[354] Ibid.
[355] Id., at 15456–61 and Commission's Exhibit No. 1596.
[356] Id., Commission's Exhibit No. 1596.
[357] Ibid.
[358] Id., at 15553.

of $10,131,079.45,[359] equivalent to 30% of the 1,900,000 shares of such stock originally sold to the public. These repurchases, the record indicates, accounted for approximately 59% of the volume of trading in the stock on the New York Curb Exchange.[360] In the same period, the corporation sold, largely through dealers and not on the New York Curb Exchange, a total of 165,586 shares of its own stock for proceeds of $3,238,731.66.[361] As at August 17, 1931, when Atlas Corporation acquired control of Chatham Phenix Allied Corporation, there were in the treasury of the corporation 399,978 shares of its own nonvoting stock which had cost the corporation $6,892,347.79.[362] Immediately upon its acquisition of control of Chatham Phenix Allied Corporation, Atlas Corporation caused this stock to be retired.[363] Thereafter, the trading activities of the corporation in its own stock were terminated by Atlas Corporation. Atlas Corporation, as will be seen later, came into control of the market in the investment company's stock.

Treating the net amount of $6,892,347.79 expended by the corporation on the purchase of its own stock and $2,640,702 [364] paid by the corporation as dividends on its stocks, as returns of capital to its security holders, the net capital paid into Chatham Phenix Allied Corporation as at August 17, 1931, when Atlas Corporation acquired control of the corporation, was $40,466,950.21.[365] On August 17, 1931, the net worth of the corporation was $31,532,445.92.[366] In the two years of the corporation's operations under the management of Chatham Phenix Corporation, its assets had shrunk in value by $8,934,405.29, a shrinkage equivalent to 22% of the net capital contributed to the enterprise.

Of the $31,532,445.92 of assets owned, at August 17, 1931, by the corporation, $10,556,993.73 consisted of the outstanding amount due to the corporation by Chatham Phenix Corporation on the open account existing between the corporations. The remainder of the assets consisted of cash and securities.

Included in the securities held by the corporation were $6,750,000 face amount of debentures of Empire State, Inc., the corporation owning the equity in the Empire State Building in New York City—the tallest building in the world. A majority of the directors of Chatham Phenix Allied Corporation and of the bank were substantially interested in the common stock of Empire State, Inc. Without the investment of Chatham Phenix Allied Corporation in these debentures, the building apparently could not have been completed in its present form.[367] These debentures of Empire State, Inc., had cost Chatham Phenix Allied Corporation $6,075,000.[368] On October 28, 1931, an

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[359] Id., Commission's Exhibit No. 1618 (Schedule 2).

[360] Ibid.

[361] Ibid.

[362] Ibid.

[363] Reply to the Commission's questionnaire for Securities Allied Corporation, Pt. II (Schedule 19).

[364] Ibid.

[365] Op. cit. supra, note 52, Commission's Exhibit No. 2003.

[366] Id., Commission's Exhibit No. 2043.

[367] Full details of Chatham Phenix Allied Corporation's investment in the debentures of Empire State, Inc., appear in Ch. II of this part of the report, pp. 123–31.

[368] Op. cit. supra, note 337, Commission's Exhibit No. 1600.

agreement [369] was concluded between Chatham Phenix Allied Corporation and Mr. Kaufman, a director of the Chatham Phenix National Bank & Trust Company, whereby he agreed to transfer to the investment company 48,000 shares of the stock of Chatham Phenix National Bank & Trust Company in exchange for the Empire State, Inc., debentures and common stock held by the investment company.[370] The 48,000 shares of the stock of Chatham Phenix National Bank & Trust Company had a market value of $1,584,000.[371] Thus, by this exchange, Chatham Phenix Allied Corporation suffered a loss on its purchases of the debentures of $4,491,000. Ultimately the loss on the entire transaction, by virtue of further depreciation in the bank's stock received in exchange, accrued interest, and other items, was increased to $5,410,390.[372]

By July 1931, the Chatham Phenix National Bank & Trust Company began to experience runs on its various branches.[373] The unsuccessful career of the Chatham Phenix Allied Corporation apparently did not aid the prestige of the Chatham National Bank & Trust Company. Mr. Kaufman testified: [374]

Q. So that when the Chatham Phenix Allied Corporation stock began to fall, it naturally had a tendency to cause a loss of confidence in the bank.

A. That is true.

Q. Which brings on the runs.

A. Yes, sir.

Q. And I am not making a very wide assumption when I say that that may have been one of the things that motivated the banking interests who indirectly controlled the investment trust to accede to the transfer of control of the investment trust, isn't that so?

A. That is true.

Q. You had the situation where the name of the bank was tied up with the investment trust, and when the market prices declined in the shares of that trust, it necessarily had to be reflected in the confidence of the depositors in the bank even though they were separate and distinct institutions.

A. That is true. I agree with you absolutely, that there should be no connection between a bank operating itself, and an investment company, in the face of all that has happened—I agree with you.

The management of the bank, by July 1931, had become convinced that the nexus between the bank and the investment company ought to be eliminated.[375] The bank management had before it two alternatives: (a) to dissolve Chatham Phenix Allied Corporation, or (b) to sell control of it. The first alternative was not seriously considered: first, because dissolution of the corporation would make clear its unsuccessful operations, and, therefore, reflect seriously on the bank's prestige; and second, because Chatham Phenix Corporation, the security affiliate of the bank, then owed to Chatham Phenix Allied

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[369] Id., Commission's Exhibit No. 1607.

[370] Id., at 15553.

[371] Id., at 15533–4.

[372] Derived from supplementary information supplied the Commission for Chatham Phenix Allied Corporation.

[373] Ibid.

[374] Op. cit. supra, note 337, at 15553–4.

[375] Id., at 15431, 15553–4.

Corporation the sum of $10,556,993.73 which it was unable to pay [376] and which it would be required to pay if Chatham Phenix Allied Corporation were dissolved.[377] In fact, the assets of Chatham Phenix Corporation, other than its holdings of Chatham Phenix Allied Corporation's securities, had a market value of $517,000.[378] Chatham Phenix Corporation also held 100,000 shares of the voting stock and 318.368 shares of the nonvoting stock of Chatham Phenix Allied Corporation.[379] The total asset value of these stocks was approximately $8,300,000.[380] The market value of these securities was approximately $6,275,520.[381] The total assets of Chatham Phenix Corporation, therefore, totaled approximately $8,817,000, valuing its holdings of Chatham Phenix Allied Corporation stock at asset value, or approximately $1,800,000 less than the sum owed to Chatham Phenix Allied Corporation in July 1931.

Mr. McRoberts conceded that the decision of the bank management not to dissolve Chatham Phenix Allied Corporation was based, at least to some extent, on the fact that a dissolution of the company when it showed large losses would reflect upon the bank's stability.[382] He also admitted that the loan due from Chatham Phenix Corporation to Chatham Phenix Allied Corporation was an obstacle to a dissolution of Chatham Phenix Allied Corporation.[383]

Having determined not to dissolve Chatham Phenix Allied Corporation, the management of the bank began to seek prospective buyers for the 100,000 shares of voting stock and the 318,368 shares of nonvoting stock of the investment company held by Chatham Phenix Corporation. Considerable negotiations were had with Tri-Continental Corporation, an investment company sponsored by J. & W. Seligman & Co., New York investment bankers.[384] However, while these negotiations were pending, Mr. Adams of E. F. Hutton & Co., members of the New York Stock Exchange, suggested Atlas Corporation as a possible purchaser of Chatham Phenix Corporation's holdings in Chatham Phenix Allied Corporation.[385] E. F. Hutton of E. F. Hutton & Co. was a director of both Chatham Phenix National Bank & Trust Company and of Chatham Phenix Allied Corporation.[386] Mr. Adams had apparently been introduced to

[376] Floyd B. Odlum, president of Atlas Corporation, which purchased these assets from the security affiliate, characterized the indebtedness of the security affiliate to the investment company as "a frozen loan" (op. cit. supra, note 52, at 17578). Mr. Odlum testified that the security affiliate "had no money to pay it," that "they had very few assets," and that he didn't think that the loan "was good" (id., at 17576–8).

[377] Op. cit. supra, note 337, at 15587–9.

[378] These assets consisted of 12,434 shares of Zonite Products Corporation common stock, 4,375 shares of the preferred and 23,324 shares of the common stock of Spiegel, May, Stern Company, Inc., and 2,475 shares of the common stock and 525 shares of the preferred stock of McKesson & Robbins, Inc. (op. cit. supra, note 52, Commission's Exhibit No. 2001, p. 107; op. cit. supra, note 337, Commission's Exhibit No. 1617; and derived from supplementary information supplied to the Commission for Atlas Corporation).

[379] Op. cit. supra, note 337, Commission's Exhibit No. 1607.

[380] Ibid.

[381] Ibid.

[382] Id., at 15587–9.

[383] Ibid.

[384] Id., at 15590.

[385] Public Examination, Atlas Corporation, at 17791.

[386] See note 340, supra.

officials of Atlas Corporation by David G. Baird, one of the several individuals engaged in finding investment companies for Atlas Corporation. E. F. Hutton & Co. eventually received from Atlas Corporation a finder's fee of $100,000.[387] Mr. Baird received $59,046.25 from Atlas Corporation for his services in connection with the acquisition of Chatham Phenix Allied Corporation.[388]

As a result of the activities of Mr. Adams and Mr. Baird, Chatham Phenix Corporation and Atlas Corporation reached an agreement on August 11, 1931, for the transfer of control of Chatham Phenix Allied Corporation to Atlas Corporation.[389] By the terms of this agreement, Atlas Corporation was to purchase the 100,000 shares of voting stock and the 318,368 shares of nonvoting stock of Chatham Phenix Allied Corporation held by Chatham Phenix Corporation at a price of $20 a share for each class of stock or a total consideration of $8,367,360. The asset value of the shares of Chatham Phenix Allied Corporation was then $19.71 a share. The market value of such shares was $15.[390] The price paid by Atlas Corporation for the stock was, therefore, $121,327 in excess of the asset value of the stock and $2,091,840 in excess of its market value.

In addition, Atlas Corporation agreed to purchase at their market price the securities of Zonite Products Corporation, Spiegel, May, Stern Company, Inc., and of McKesson & Robbins, Inc., which constituted the remaining assets of Chatham Phenix Corporation. These securities were acquired, however, not by Atlas Corporation, but by Chatham Phenix Allied Corporation, which on August 17, 1931, the date Atlas Corporation actually acquired control of Chatham Phenix Allied Corporation, purchased these securities from Chatham Phenix Corporation at their market value, $517,900.[391]

The agreement required Atlas Corporation to make a down payment on the Chatham Phenix Allied Corporation shares of $1,367,360 on August 12, 1931.[392] The payment of the remaining $7,000,000 was to be made by Atlas Corporation on or before August 21, 1931.

Atlas Corporation did not at the time have available the $8,367,360 in cash which was required to consummate the purchase. The down payment of $1,367,360 which was to be made on August 12, 1931 was realized by a loan in that amount made by Atlas Corporation from General Empire Corporation, one of its subsidiaries. This sum constituted 30% of the assets of General Empire Corporation. To provide cash for the loan, General Empire Corporation liquidated a large portion of its portfolio of marketable securities. Although 35% of the outstanding stock of General Empire Corporation was held by the public, because of a "mistake" no interest was paid by Atlas Corporation on the loan. The loan was repaid on August 28, 1931.[393]

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387 Op. cit. supra, note 385, Commission's Exhibit No. 1969.
388 Ibid.
389 Op. cit. supra, note 337, Commission's Exhibit No. 1617.
390 Id., at 15596 and Commission's Exhibit No. 1618.
391 Op. cit. supra, note 385, Commission's Exhibit No. 2001 (p. 107).
392 Op. cit. supra, note 337, Commission's Exhibit No. 1617.
393 Op. cit. supra, note 385, at 17934; Commission's Exhibit No. 2001 (p. 108).

On August 17, 1931, Atlas Corporation borrowed $7,000,000 from Bankers Trust Company of New York and completed its purchase of the 100,000 shares of voting stock and the 318,368 shares of non-voting stock of Chatham Phenix Allied Corporation.[394] The ownership of the 100,000 shares of voting stock which constituted all of the voting stock of Chatham Phenix Allied Corporation put Atlas Corporation in control of Chatham Phenix Allied Corporation. On August 17, 1921, all of the directors of Chatham Phenix Allied Corporation resigned and were replaced by representatives of Atlas Corporation. The name of the corporation was then changed to Securities Allied Corporation pursuant to a clause in the agreement of Atlas Corporation with Chatham Phenix Corporation requiring the elimination from the corporate title after transfer of control of Atlas Corporaton of any reference to Chatham Phenix National Bank & Trust Company.[395]

The $8,885,260 derived by Chatham Phenix Corporation on the sale to Atlas Corporation of the securities of Chatham Phenix Allied Corporation and on the sale of the securities of Zonite Products Corporation, Spiegel, May, Stern Company, Inc., and McKesson & Robbins, Inc., were used in conjunction with funds borrowed by Chatham Phenix Corporation from the Chatham Phenix National Bank & Trust Company, to repay on August 17, 1931, the outstanding obligation of Chatham Phenix Corporation to Chatham Phenix Allied Corporation in the sum of $10,556,993.73.[396] Atlas Corporation as a condition of its agreement to purchase control of Chatham Phenix Allied Corporation had required this loan to be paid simultaneously with the transfer of control of the investment company.

Atlas Corporation thus acquired control of the sum it had expended to acquire control of Chatham Phenix Allied Corporation. In addition, it had acquired control of approximately $21,000,000 of other assets. In effect, Atlas Corporation had acquired control of Chatham Phenix Allied Corporation in consideration of the release of the indebtedness of the security affiliate to Chatham Phenix Allied Corporation.

It remained, however, for Atlas Corporation to repay its loans totaling $8,367,360 made by General Empire Corporation and Bankers Trust Company. To accomplish this, the cash which Chatham Phenix Allied Corporation had received from Chatham Phenix Corporation in payment of the latter's indebtedness was used by Chatham Phenix Allied Corporation to purchase from Atlas Corporation, and several of its subsidiaries, various securities of investment companies, control of which had already been acquired or was in process of being acquired by Atlas Corporation.[397]

On August 17, 1931, the date on which Atlas Corporation acquired control of Chatham Phenix Allied Corporation, Atlas Corporation

[394] Ibid.

[395] Op. cit. supra, note 337, Commission's Exhibit No. 1617.

[396] Derived from supplementary information supplied the Commission for Atlas Corporation.

[397] Op. cit. supra, note 385, Commission's Exhibit No. 2001 (p. 109 et seq.).

itself sold to Chatham Phenix Allied Corporation, at their market prices, for total proceeds of $962,918, the following securities:

	Number of shares
Aviation Securities Corporation, capital stock	48, 290
Aviation Securities Corporation, option warrants	43, 834
American Investors, Inc., Class B common stock	2, 600
American Capital Corporation, Class B common stock	1, 200
Chain Store Stocks, Inc., capital stock	400
Federated Capital Corporation, common stock	31, 600
Federated Capital Corporation, preferred stock	1, 687
International Mining Corporation	7, 700

On the same day Atlas Utilities & Investors Co., Ltd., the Canadian subsidiary of Atlas Corporation, sold to Chatham Phenix Allied Corporation for proceeds of $5,397,008.76 the following securities:

	Number of shares
American European Securities Company, capital stock	4, 000
Blue Ridge Corporation, common stock	2, 400
Securities Corporation General, common stock	23, 950
Chain Store Stocks, Inc., capital stock	1, 300
Allied Atlas Corporation, capital stock	262, 457½

All of these securities were purchased by Chatham Phenix Allied Corporation at their market prices with the exception of the shares of Allied Atlas Corporation which represented approximately 90% of the outstanding stock of Allied Atlas Corporation. These shares were acquired by Chatham Phenix Allied Corporation at their asset value. Out of the proceeds of $5,397,008.76 realized by Atlas Utilities & Investors Co., Ltd., on the sale of the above-mentioned securities to Chatham Phenix Allied Corporation, Atlas Utilities & Investors Co., Ltd., paid $2,260,000 which it owed to Atlas Corporation, and in addition loaned to Atlas Corporation $3,000,000. Atlas Corporation thus derived $5,260,000 of the proceeds of the sale of these securities to Chatham Phenix Allied Corporation by Atlas Utilities & Investors Co., Ltd.

On August 17, 1931, Iroquois Share Corporation, another Atlas Corporation subsidiary, transferred to Chatham Phenix Allied Corporation, for a cash consideration of $1,155,528.75, the following securities at their market prices:

	Number of shares
American Investors, Inc., common stock, Class B	37, 700
Prudential Investors, Inc., capital stock	26, 300
Ungerleider Financial Corporation, capital stock	10, 000
Federated Capital Corporation, preferred stock	19, 000
Sterling Securities Corporation, Class B common stock	21, 350
Union Natural Gas Co. of Canada, common stock	1, 536

These securities constituted virtually all the assets of Iroquois Share Corporation. Iroquois Share Corporation, on the same day, was dissolved and Atlas Corporation, as the holder of over 95% of its stock, received on August 17, 1931 a liquidating dividend in cash of $1,200,000. This sum included the proceeds of the sale of the above-mentioned securities to Chatham Phenix Allied Corporation by Iroquois Share Corporation.

Selected Stocks, Inc., another Atlas Corporation subsidiary, also on August 17, 1931, sold to Chatham Phenix Allied Corporation its entire

portfolio of securities for proceeds of $553,462.50.[398] The securities sold by Selected Stocks, Inc. to Chatham Phenix Allied Corporation were sold at their market prices and were as follows:

	Number of shares
American Investors, Inc., Class B stock	85,100
Prudential Investors, Inc., capital stock	900
Sterling Securities Corporation, preference stock	12,400

On August 17, 1931, Atlas Corporation caused Selected Stocks, Inc. to be dissolved and to pay to Atlas Corporation as a liquidating dividend on its holdings of Selected Stocks, Inc. securities, the sum of $530,000. These funds so paid to Atlas Corporation by Selected Stocks, Inc. were derived by that company from the sale of its portfolio on the same day to Chatham Phenix Allied Corporation.[399]

In addition, on August 17, 1931, Atlas Corporation caused Jackson & Curtis Investment Associates to be dissolved and to pay Atlas Corporation, its largest stockholder, $722,016.88[400] in cash as a liquidating dividend on the Atlas Corporation's holdings of its certificates of beneficial interest.

As a result of these various transactions, Atlas Corporation received directly or indirectly from Chatham Phenix Allied Corporation cash payments from the sales of the above described securities totaling $7,830,902[401] most of which it immediately utilized to repay its loan of $1,367,360 from General Empire Corporation and its loan of $7,000,000 from Bankers Trust Company.

The very process of acquisition of control of Chatham Phenix Allied Corporation by Atlas Corporation thus involved a change in the investment policies of the corporation. By the purchases of the securities mentioned from Atlas Corporation and its subsidiaries on August 17, 1931, approximately $8,068,918[402] of the then gross assets of approximately $31,000,000 of Chatham Phenix Allied Corporation were represented by the securities of investment companies, control of which had been acquired by Atlas Corporation or was in the process of acquisition by Atlas Corporation. These securities of investment companies constituted 26% of the then total assets of Chatham Phenix Allied Corporation. Chatham Phenix Allied Corporation controlled Allied Atlas Corporation which controlled All America General Corporation. Allied Atlas Corporation and All America General Corporation, together, held in the aggregate approximately 40% of the stock of Ungerleider Financial Corporation. In addition, Chatham Phenix Allied Corporation had acquired all the Atlas Corporation's holdings in Federated Capital Corporation and in Aviation Securities Corporation.

In September 1931, as will be indicated, Chatham Phenix Allied Corporation acquired control of Chain Store Stocks, Inc.[403] In October 1931, Chatham Phenix Allied Corporation acquired control of National Securities Investment Company.[404]

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[398] Id., Commission's Exhibit No. 2001 (p. 110).
[399] Ibid.
[400] Id., Commission's Exhibit No. 2001 (pp. 104, 110).
[401] Ibid. (p. 110).
[402] Id., at 17577.
[403] See infra, pp. 1306–16.
[404] See supra, pp. 1094–1119.

By December 31, 1932, Chatham Phenix Allied Corporation's security investments, having a market value of $16,559,604.85,[405] included securities of investment companies under its control or under the control of Atlas Corporation, totaling $13,716,510.[406] In other words, 82% of the portfolio of Chatham Phenix Allied Corporation was represented by the securities of investment companies. By December 8, 1933 when Chatham Phenix Allied Corporation was dissolved, $26,769,284.49 [407] of its assets, at cost of approximately $31,000,000 consisting of cash and diversified securities when Atlas Corporation acquired control of the corporation, were invested in securities of investment companies. By December 8, 1933, when Chatham Phenix Allied Corporation was dissolved, it had become the key company in the Atlas Corporation structure of companies. It had purchased substantial interests in nearly all of the companies subsequently acquired by Atlas Corporation. Table 17 illustrates the holdings of Chatham Phenix Allied Corporation as at December 8, 1933, in all of the companies in the Atlas Corporation system.

TABLE 17.—*Percentage of outstanding securities of investment companies in the Atlas Corporation group, held by companies in the group, Dec. 8, 1933*

	Held by Securities Allied Corporation [a] [b]		Held by other companies in Atlas group		Total holdings by Atlas group		Minority holdings	
	Common	Preferred	Common	Preferred	Common	Preferred	Common	Preferred
All America General Corporation	80.31	--------	18.91	--------	99.21	--------	0.79	--------
Allied Atlas Corporation	93.47	--------	3.61	--------	97.08	--------	2.92	--------
American, British & Continental Corporation [c]	--------	37.20	68.29	15.25	68.29	52.45	31.71	47.55
American Investors, Inc	26.83	4.99	47.31	52.60	74.14	57.59	25.86	42.41
Atlantic Securities Corporation	--------	--------	97.83	98.16	97.83	98.16	2.17	1.84
Atlas Utilities & Investors Co., Ltd	--------	--------	100.00	--------	100.00	--------	--------	--------
Aviation Securities Corporation	77.08	--------	20.79	--------	97.87	--------	2.13	--------
Blue Ridge Corporation	.04	2.85	87.84	18.43	87.88	21.28	12.12	78.72
Chain Store Stocks, Inc	68.96	--------	26.57	--------	95.53	--------	4.47	--------
Federated Capital Corporation	20.24	60.82	35.38	30.21	55.62	91.05	44.38	8.95
Financial Corporation, The	54.53	--------	42.82	--------	97.35	--------	2.65	--------
General Empire Corporation	11.44	--------	87.68	--------	99.12	--------	.88	--------
National Securities Investment Co	74.38	60.03	12.97	28.36	87.35	88.39	12.65	11.61
Pacific Eastern Corporation	7.64	--------	54.40	--------	62.04	--------	37.96	--------
Shenandoah Corporation	.10	5.26	58.32	65.46	58.42	70.72	41.58	29.28
Sterling Securities Corporation [d]	13.56	26.24	79.91	36.02	83.47	62.26	16.53	37.74

[a] 100% of voting stock was held by Atlas Utilities Corporation (name changed to Atlas Corporation); the nonvoting stock was held as follows: 91% by Atlas Utilities Corporation (name changed to Atlas Corporation); 4.35% by Atlantic Securities Corporation; 1.45% by National Securities Investment Co.; and 3.2% by minority stockholders.

[b] Dissolved Dec. 8, 1933; the former name was Chatham Phenix Allied Corporation.

[c] In addition, bonds of American, British & Continental Corporation were held as follows: 46.28% by companies in the Atlas group other than Securities Allied Corporation; and 53.72% by others.

[d] In addition, preference and class A stock of Sterling Securities Corporation were held as follows: 7.8% preference and 3.88% class A by Securities Allied Corporation; 17.97% preference and 24.76% class A by others in Atlas Corporation group; 25.77% preference and 28.64% class A total holdings by Atlas Corporation group; and 74.23% preference and 71.36% class A by other stockholders.

[405] Op. cit. supra, note 385, Commission's Exhibit No. 2039.

[406] Ibid.

[407] Id., Commission's Exhibit No. 2040.

Mr. Odlum stated that he informed Mr. McRoberts of his intent to repay, in the manner which has been described, the loans made by Atlas Corporation to acquire control of Chatham Phenix Allied Corporation and of his intent to have Chatham Phenix Allied Corporation participate in the Atlas Corporation program of investment company acquisitions.[408] Stockholders of Chatham Phenix Allied Corporation first became aware of this policy on December 24, 1931, when it was revealed by Atlas Corporation in the financial report of Securities Allied Corporation for the period ending November 30, 1931.[409]

Mr. Odlum further testified that the net effect of these various transactions by which Atlas Corporation acquired control of Chatham Phenix Allied Corporation was to replace the "frozen loan" of $10,000,000 owed by Chatham Phenix Corporation with $8,000,000 in securities of investment companies controlled by Atlas Corporation and $2,000,000 in cash.[410]

Despite the fact that the public, which on August 17, 1931, held 1,181,654 shares of the nonvoting stock of Chatham Phenix Allied Corporation, had presumably relied on the representation that Chatham Phenix Corporation had acquired all of the voting stock of Chatham Phenix Allied Corporation for "investment" and had further relied on a continuance of the management of their corporation by Chatham Phenix Corporation, Mr. McRoberts testified that the stockholders were not consulted with reference to the shift in the management of their corporation on August 17, 1931, but that they were informed of the transfer of control to Atlas Corporation only after it had occurred.[411] Nor is there any evidence that the stockholders were consulted on the contemplated change by Atlas Corporation of the investment policy of their corporation.

Mr. McRoberts also admitted he was aware of the fact that Atlas Corporation intended to acquire, if possible, the public holdings of the nonvoting stock of Chatham Phenix Allied Corporation at prices less than their asset value.[412] In fact, he testified that Atlas Corporation had refused to make an offer to acquire the public holdings at the same price that Atlas Corporation had acquired the holdings of Chatham Phenix Corporation. Mr. McRoberts' testimony was as follows:[413]

Q. Do you recall in your original offering circular that you said you were purchasing the 100,000 (voting shares) for a permanent investment?

A. Well that was perfectly true. At that time I had no intention of selling it.

Q. Was there any discussion with the Atlas interest that they would make the same offer to other stockholders that they were making to you?

A. Oh, yes.

Q. That they would get exactly the same price that you were getting?

A. No. I don't think that was part of—there was a discussion of it yes, but it didn't culminate in any agreement to that effect.

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[408] Op. cit. supra, note 337, at 15594.

[409] Reply to the Commission's questionnaire for Securities Allied Corporation, Pt. I.

[410] Op. cit. supra, note 385, at 17578–9.

[411] Op. cit. supra, note 337, at 15595–6.

[412] Ibid.

[413] Id., at 15591–8.

Q. Was there any discussion with Mr. Odlum or any representative of the Atlas Corporation as to what the future investment policy of this investment trust would be?

A. Yes.

Q. What was the discussion about?

A. Well their policy was to do just what we were doing with our own stock.

Q. What was that?

A. We were buying the stock when it was offered materially below the book value. They were doing it not only with their own stock but with other investment trust stocks. In other words, they were in a position to do it in a very much broader way than we were.

Q. You say Mr. Odlum told you after he got control he was going to use all the funds of the Chatham Phenix Allied Corporation to buy other investment trusts?

A. When he could buy them on that basis. That was his main operation at that time.

Q. What did he say his main operation was?

A. Buying investment trust stocks where they would be bought materially below the liquidating value of the company.

Q. As far as your stock was concerned, he was not buying that below liquidating value, was he?

A. I don't know whether he was buying any of our stock or not. You mean the transaction?

Q. Yes.

A. No, he didn't.

Q. So he couldn't make any money that way because the liquidating value was $19 a share and he was paying you $20 a share?

A. Well, that is for the control. That was to get control of the company.

Q. So that in order to get control of the company, not only was he not buying the stock at a discount, but he was paying this slight premium?

A. Yes; I tried to get him to pay a larger premium but he didn't do it.

Q. He had some purpose in getting control?

A. Perfectly right.

Q. Did he tell you why he was anxious to get control?

A. Well, they were a large concern rated at about 25 or 30 million. This was a large block that would bring him up to a strong position. I mean as to size and so forth. That was really his object in acquiring the stock.

Q. Did you say Mr. Odlum or any representative of the Atlas Corporation would make provisions to give $20 a share to the other stockholders at this time?

A. We discussed it, yes; but they wouldn't do it.

Q. So that the Chatham Phenix Corporation sponsored the investment trust and was in absolute control of the investment trust through this entire period both by the ownership of every share of voting stock and through being all the directors and officers and Chatham Phenix Corporation, who were the underwriters and distributors of the stock to the public, turned over control of this investment trust to the Atlas interests before it even disclosed it to the stockholders.

A. Yes; that is true.

* * * * * * *

Q. You don't deny you got a good price under the circumstances?

A. I got the best price I could.

Q. But as far as the other stockholders were concerned, there was no provision to get them the best price?

A. No; but I think it was doing a good service to the other stockholders when we did what we did.

Q. Did the Chatham Phenix Corporation retain any portion of that stock in the Allied Corporation so that they could avail themselves of a good service that was being rendered to the stockholders?

A. No; I don't think so.

Q. They sold every single share?

A. That was a condition of the trade.

As Mr. McRoberts testified, no provision for equal treatment of the public holders of Chatham Phenix Allied Corporation's nonvoting stock was agreed upon by Atlas Corporation and Chatham Phenix Corporation. The treatment to be accorded to these stockholders, as far as prior exchange offers were concerned, was left to Atlas Corporation. Atlas Corporation, in line with its usual policy, would seek to acquire the shares of Chatham Phenix Allied Corporation held by the public at prices less than the asset value of such shares. Control of the market price of the shares was, therefore, essential to Atlas Corporation. The agreement of August 11, 1931, between Atlas Corporation and Chatham Phenix Corporation expressly stipulated that Atlas Corporation was to be in control of the market price of the nonvoting stock of Chatham Phenix Allied Corporation. The contract provided that:[414]

It is to be understood that the market in shares of Chatham Phenix Allied Corporation is to be in our (Atlas) sole control from now on, and to that end, your corporation and its affiliates shall not deal further in such shares without our previous consent.

Atlas Corporation and its subsidiary investment companies, almost immediately upon acquisition of control of Chatham Phenix Allied Corporation, began to accumulate the nonvoting stock of the corporation by purchases of the stock in the open market at market prices which represented substantially only the bids of Atlas Corporation and its subsidiaries. The market prices so established, although higher than the existing market price of comparable investment company securities, were substantially below the asset value of the stock of Chatham Phenix Allied Corporation. By December 31, 1931, Atlas Corporation and its subsidiaries had acquired a total of 533,988 shares of the nonvoting stock of Chatham Phenix Allied Corporation, equivalent to 35 percent of the 1,500,022 shares of such stock then outstanding. In addition, Atlas Corporation owned the 100,000 shares of voting stock of the investment company.

On June 4, 1932, Atlas Corporation supplemented its market purchases of Chatham Phenix Allied Corporation nonvoting stock by making on offer[415] to exchange one share of its common stock and one-fifth of one of its option warrants for each share of the nonvoting stock of Chatham Phenix Allied Corporation. This offer was one of 12 simultaneous offers made by Atlas Corporation to the stockholders of each of its then controlled investment companies.

The offer of Atlas Corporation stated that the asset value of each share of Chatham Phenix Allied Corporation's nonvoting stock based

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[414] Id., Commission's Exhibit No. 1617.

[415] Op. cit. supra, note 385, Commission's Exhibit No. 1970.

on the market value of its security holdings was $8.50 a share.[416] However, it was revealed that if the holdings of Atlas Corporation controlled investment companies in the portfolio of Chatham Phenix Allied Corporation were taken at their asset rather than their market values the asset value of each Chatham Phenix Allied Corporation share would be $13.25.[417]

The difference in these values presumably may have influenced Chatham Phenix Allied Corporation stockholders to exchange their shares for Atlas Corporation shares. Only in this way would the stockholders share in the actual value of the assets of the corporation. On the dissolution of Chatham Phenix Allied Corporation, the calculation of the per share cash asset value of the corporate assets might be based not on the asset values but on the market values of Chatham Phenix Allied Corporation's holdings of the securities of Atlas Corporation controlled companies. The difference between the value of the assets of Chatham Phenix Allied Corporation received by Atlas Corporation on the dissolution of the corporation and the cash value of the assets received by minority stockholders of the corporation will be indicated below.

In contrast, the actual asset value of the Atlas Corporation common stock offered in exchange was $2.97.[418] This fact was not revealed in the offer. However, the offer disclosed the fact that, if all the stockholders of the 12 investment company subsidiaries of Atlas Corporation accepted the exchange offer of Atlas Corporation securities simultaneously made to them on June 4, 1932, the asset value of the common stock of Atlas Corporation would be $7.30 a share. On the basis of the then actual asset value of the common stock of Atlas Corporation, stockholders of Chatham Phenix Allied Corporation making the exchange, therefore, suffered a gross loss in assets per share of their stock of $5.53 based on the market value of the portfolio holdings of their company and of $10.20 per share of their stock based on the underlying asset value of the Atlas Corporation controlled investment company securities in their corporation's portfolio.[419] On the basis of the asset value of $7.30 for each share of Atlas Corporation common stock, which would exist if all stockholders of all of its subsidiaries accepted its exchange offer of June 4, 1932, stockholders of Chatham Phenix Allied Corporation who accepted the exchange offer would have suffered a loss in asset values per share of their stock of $1.20 based on the market value of the portfolio holdings of their company and of $5.95 a share of their stock based on the underlying asset value of the Atlas Corporation controlled investment company securities then in the portfolio of Chatham Phenix Allied Corporation.

The Atlas Corporation securities offered in exchange had a market value 75 cents in excess of the market value of the Chatham Phenix Allied Corporation stock.[420] In other words, accepting stockholders

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[416] Ibid.

[417] Ibid.

[418] Id., Commission's Exhibit No. 2001 (p. 115).

[419] Ibid. However, stockholders who accepted the Atlas Corporation offer would, by becoming stockholders of Atlas Corporation, recover to some extent a portion of their gross loss in asset values.

[420] Op. cit. supra, note 385, Commission's Exhibit No. 2001 (p. 115).

of Chatham Phenix Allied Corporation exchanged a higher asset value for a higher market value of securities.

On September 23, 1932, the Atlas Corporation exchange offer was renewed and an alternate offer of one-fourth of a share of Atlas Corporation preference stock for each share of Chatham Phenix Allied Corporation stock was made. The asset value of the Atlas Corporation preference stock offered equaled the asset value of the stock of Chatham Phenix Allied Corporation and the market value of the Atlas Corporation preference stock exceeded the market value of the Chatham Phenix Allied Corporation stock by approximately $2.

As a result of these offers, Atlas Corporation acquired 544,272 shares of Chatham Phenix Allied Corporation nonvoting stock. The loss in asset values to stockholders of Chatham Phenix Allied Corporation who accepted these offers was $2,736,880,[421] on the basis of an asset value of $8.50 a share of Chatham Phenix Allied Corporation stock, and approximately $4,000,000 if the asset value of the Chatham Phenix Allied Corporation stock is taken at $13.25 a share.

On March 13, June 13, and July 12, 1933, additional Atlas Corporation offers[422] to exchange one share of its common stock and one-fifth of one of its option warrants for each share of Chatham Phenix Allied Corporation nonvoting stock, were made. Over the period of these offers, the average asset value of the Chatham Phenix Allied Corporation nonvoting stock was $13.64 and that of the unit of Atlas Corporation securities offered in exchange was $8.55.[423] Stockholders of Chatham Phenix Allied Corporation accepting the exchange suffered a gross per share loss in asset values of $5.09.[424] However, over the same period the market value of the Atlas Corporation unit of securities was $1.85[425] in excess of the market value of Chatham Phenix Allied Corporation shares.

As a result of these offers, Atlas Corporation acquired an additional 135,676 shares of the stock of Chatham Phenix Allied Corporation. The loss in asset values to Chatham Phenix Allied Corporation stockholders on accepting this exchange was $607,806.[426]

By December 8, 1933, when Chatham Phenix Allied Corporation was dissolved, Atlas Corporation and its controlled companies had acquired by purchase or exchange 1,334,057 of the nonvoting shares and the 100,000 voting shares of Chatham Phenix Allied Corporation.[427] These holdings constituted 96.71% of the 1,478,129 shares of the capital stock of Chatham Phenix Allied Corporation then outstanding. The minority stockholders held 43,972 shares.[428]

e. Monthly Income Shares, Inc.—Donald P. Kenyon

Donald P. Kenyon's activities in the acquisition of investment companies are described in detail in Chapter II of this part of the

[421] Id., Commission's Exhibit No. 2001 (p. 118) ; see, however, note 419, supra.
[422] Id., Commission's Exhibit No. 1970.
[423] Based on prices as of April 30. 1933. Id., Commission's Exhibit No. 2001 (p. 118).
[424] Ibid.
[425] Ibid.
[426] Id., Commission's Exhibit No. 2001 (p. 119) ; see, however, note 419, supra.
[427] Ibid.
[428] Certain aspects of the dissolution of Chatham Phenix Allied Corporation are discussed infra, pp. 1453–7.

report.[429] The apparent objective of Mr. Kenyon was to acquire control of investment companies for the purpose of applying their assets to his own use. To secure control of the assets of investment companies Mr. Kenyon was willing to pay substantial premiums for their controlling shares.[430] The acquisitions of control of Monthly Income Shares, Inc., of New York and of Monthly Income Shares, Inc., of New Jersey are examples of Mr. Kenyon's use of this technique.

The Monthly Income Shares companies were incorporated in 1933 and 1934 under the auspices of Robert E. Lancaster,[431] who had been convicted of a crime in California in 1928 and until 1938 was a fugitive from justice.[432] The corporations confined the distribution of their securities to the residents of New York and New Jersey, the states of incorporation of Monthly Income Shares, Inc., of New York and Monthly Income Shares, Inc., of New Jersey, respectively.[433] Both corporations had identical capitalizations, consisting of Class A nonvoting stock entitled on liquidation of the corporation to a first claim against assets of $1 a share plus ten-elevenths of the remaining assets after prior payment of 40 cents a share on the Class B stock, and a Class B voting common stock.[434] The charters of both corporations forbade loans of the corporation's funds to officers, directors, and the holders of the Class B stock and required that at least 50% of the corporate assets consist of cash, United States Government bonds, and/or securities listed on either the New York Stock Exchange or the New York Curb Exchange.[435]

Mr. Lancaster, through a corporation, Lancaster, Havens & O'Brien, Inc., controlled by him, distributed the Class A stock of both corporations to the public.[436] Mr. Lancaster and his associates purchased 10,000 shares of the Class B stock of the New Jersey corporation and all of the outstanding 20,000 shares of the Class B stock of the New York corporation.[437]

In February 1936, Monthly Income Shares, Inc., of New York had outstanding 206,185 shares of Class A stock and had total assets of $158,267.[438] The New Jersey corporation then had outstanding

[429] See Ch. II of this part of the report, pp. 309–49.

[430] Ibid.

[431] Public Examination, Alpha Shares, Inc., et al., Commission's Exhibits Nos. 3079 (p. 2), 3081.

[432] Derived from supplementary information supplied the Commission for Investors Fund of America, Inc.

[433] Op. cit. supra, note 431, Commission's Exhibits Nos. 3079 (p. 2), 3079 (p. 3), and 3081. By thus confining the offering of the securities of these companies to one state, Mr. Lancaster avoided the necessity of registration under Section 3 (a) (11) of the Securities Act of 1933.

[434] Id., Commission's Exhibits Nos. 3079, 3081.

[435] *People, etc.* v. *Monthly Income Shares, Inc., et al.*, Supreme Court of the State of New York, Kings County (Consent Decree entered May 14, 1935), bill of complaint, Exhibit A, p. 19.

[436] Op. cit. supra, note 431, Commission's Exhibits Nos. 3079 (p. 2) and 3081; *People, etc.* v. *Monthly Income Shares, Inc., et al.*, Supreme Court of the State of New York, Kings County (Consent Decree entered May 14, 1935), affidavit of Robert R. Wilson, Senior Accountant, Bureau of Securities of the New York State Department of Law, submitted in support of bill of complaint, p. 52.

[437] Op. cit. supra, note 431, at 19477 and Commission's Exhibit No. 3079 (p. 4); *People, etc.* v. *Monthly Income Shares, Inc., et al.*, op. cit. supra, note 436, p. 54.

[438] Op. cit. supra, note 431, Commission's Exhibit No. 3083.

88.517 shares of Class A stock and had total assets of $85,017.44.[439] Since the assets of both corporations were insufficient to meet the preferences[440] in assets to which the Class A stockholders were entitled on a dissolution of the corporations, the Class B shares held by Mr. Lancaster and his associates were without asset value.

On February 14, 1936 Mr. Kenyon agreed to purchase all of Mr. Lancaster's holdings of the Class B stock of the Monthly Income Shares companies and his holdings of all of the common stock of Lancaster, Havens & O'Brien, Inc., and all of the common stock of National Associated Dealers, Inc. (another distributing organization controlled by Mr. Lancaster), for a total consideration of $60,000.[441] The Class B stock of the Monthly Income Shares companies, and the common stock of National Associated Dealers, Inc., were without any asset value.[442] The record does not indicate the value of the common stock of Lancaster, Havens & O'Brien, Inc., but presumably its value, if any, consisted substantially of the good will of its dealers. Mr. Kenyon did not thereafter operate Lancaster, Havens & O'Brien, Inc. It seems evident that the payment of $60,000 made to Mr. Lancaster was substantially in excess of the actual value of the shares sold by him to Mr. Kenyon.

The contract with Mr. Lancaster required a down payment of $10,000 on February 14, 1936, and $30,000 on February 19.[443] Mr. Kenyon obtained $8,000 of the amount required for the down payment by the sale to Alpha Shares, Inc., another investment company controlled by Mr. Kenyon, of 80 shares of Kenyon & Company, Incorporated, a dummy corporation having no assets and owned by Mr. Kenyon.[444] The purchase price of these securities represented approximately 20% of the then approximately $42,700 of assets of Alpha Shares, Inc.[445] Mr. Kenyon also recouped a substantial portion of the purchase price of the control of the Monthly Income Shares companies by selling to Alpha Shares, Inc., 5,000 shares of Monthly Income Shares, Inc., of New Jersey,[446] 3,000 shares of Monthly Income Shares, Inc., of New York,[447] 3,000 shares of common stock of National Associated Dealers, Inc.[448] and 10 additional

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[439] Hearing *In the matter of Donald P. Kenyon, Clark R. Kenyon, Norman E. Dizon, George Grantham, Edwin Embree, Harry Pasternak, Kenyon & Company, Inc.,* held on April 28, 1937, pursuant to order for investigation dated April 28, 1937, under Sections 19 (b) and 20 (a) of the Securities Act of 1933, pp. 229–230, and Commission's Exhibits Nos. 72, 73, 74, 75.

[440] According to the charters of incorporation of Monthly Income Shares, Inc., of New York and Monthly Income Shares, Inc., of New Jersey, the Class A stock of these companies was entitled upon liquidation to $1 a share (op. cit. supra, note 431, Commission's Exhibits Nos. 3079, 3081).

[441] Id., Commission's Exhibits Nos. 3079 (p. 7), 3149.

[442] Id., at 19695–8.

[443] Id., Commission's Exhibits Nos. 3079 (p. 7), 3149.

[444] Id., at 19683–4. Kenyon & Company, Incorporated, was organized as a company to act merely as an instrumentality which Mr. Kenyon used to facilitate his various transactions (id., at 20069–70, Commission's Exhibit No. 3121). This company was characterized by Mr. Dizer as Mr. Kenyon's "conduit" (id., at 19738). The corporation did not even keep a set of books until 1936, when a set of books was written to comply with a subpoena duces tecum (id., at 20068).

[445] Summary statement filed with the Commission for Alpha Shares, Inc.

[446] Op. cit. supra, note 431, at 19687.

[447] Id., at 19690–1 and Commission's Exhibit No. 3111.

[448] Id., at 19691 and Commission's Exhibits Nos. 3112, 3113.

shares of Kenyon & Company, Incorporated,[449] for a total consideration of $18,000.[450] All of these securities were worthless from the viewpoint of asset values at that time.[451] Thus, $26,000 of the funds expended by Mr. Kenyon to acquire control of Monthly Income Shares, Inc. of New Jersey, had been derived from Alpha Shares, Inc.

To return to the Monthly Income Shares companies, it is doubtful that their Class A stockholders were informed of the shift in control of their corporations. In fact, such stockholders had never received financial reports from their corporations.

Mr. Lancaster continued, through the medium of new distributing companies which he had formed, to distribute the Class A stock of the Monthly Income Shares companies until July 31, 1936, when, as a result of the refusal of Mr. Kenyon to supply him with financial statements of the corporations, Mr. Lancaster canceled his distribution arrangements with the corporations.[452] The record does not indicate that Mr. Lancaster, who had sold to the public all of the Class A stock of these corporations, took any affirmative steps looking to the protection of the interests of such stockholders.

Mr. Kenyon, on his accession to control of the two Monthly Income Shares companies, caused himself and his nominees to be elected directors of both companies [453] and almost immediately caused them to pledge their entire portfolios for loans. The moneys so borrowed were loaned to Mr. Kenyon and his associates.[454] The charter provisions of both companies, which forbade loans to directors and holders of their Class B stock,[455] were utterly disregarded by Mr. Kenyon.

In order to derive further funds for his own use at the expense of the two investment companies, Mr. Kenyon, in June 1936, caused both of these companies to amend their charter to provide for the

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[449] Id., at 19694.

[450] $5,000 was paid for the 5,000 shares of Monthly Income Shares, Inc., of New Jersey, $4,500 for 3,000 shares of Monthly Income Shares, Inc., of New York; $7,500 for the 3,000 shares of National Associated Dealers, Inc., and $1,000 for the 10 shares of Kenyon & Company, Incorporated.

[451] With respect to Monthly Income Shares, Inc., of New Jersey, Louis J. Carr, the accountant for the company, testified (id., at 19689) that the stock had a maximum book value as of the date of sale of "three to five cents" a share. Later in the examination (id., at 19690) Mr. Carr stated that he wanted to change this testimony to the effect that the Class B stock had no book value whatsoever. The Class B stock of Monthly Income Shares, Inc., of New York was likewise without asset value (id., at 2006). The common stock of National Associated Dealers, Inc., was also without asset value and no dividend had ever been paid on it (id., at 19695–8). Likewise, the stock of Kenyon & Company, Incorporated, was without asset value. (See supra, p. 1159.)

[452] Op. cit. supra, note 431, Commission's Exhibit No. 3079.

[453] Id., at 19479. Donald Kenyon caused himself, his brother, Charles Russell Kenyon, and Norman E. Dizer, one of his associates, to be elected as officers of the companies (ibid.).

[454] Mr. Kenyon caused Monthly Income Shares, Inc., of New York to pledge practically the whole portfolio as collateral for loans from Lawyers Trust Company of New York and from Maloney, Anderson & Block, a brokerage firm. The total amount borrowed from the bank and the brokerage firm was $109,700. The securities pledged with Lawyers Trust Company were valued, on a cost basis, at $145,391.88, and with Maloney, Anderson & Block, on the same basis, at $12,267.50, or a total of $157,659.38 (id., Commission's Exhibit No. 3087). All this money was immediately lent ostensibly to George R. Grantham and Kenyon & Company, Incorporated, but actually it was lent to Mr. Kenyon to whom the ostensible borrowers turned it over after its receipt by them (id., at 19601–2, 19738). Mr. Kenyon effected similar transactions with Monthly Income Shares, Inc., of New Jersey (ibid.).

[455] *People, etc. v. Monthly Income Shares, Inc., et al.*, op. cit. supra, note 435.

issuance of a Class AA stock with a 25 cents par value. This stock was, in fact, subordinate in asset and dividends preferences to the existing Class A stock.[456] Since the assets of both companies, even after the issuance of the Class AA stock, were insufficient to cover the preference of the Class A stocks upon a dissolution of the companies, the newly created Class AA stocks were without asset value.[457] Nevertheless, Mr. Kenyon sold 115,000 shares of the new Class AA stock of Monthly Income Shares, Inc., of New Jersey and 135,000 shares of the same class of stock of Monthly Income Shares, Inc., of New York, to Investors Fund of America, Inc., another investment company under his control, for a total of $260,000.[458] The proceeds of these sales were not turned over to the Monthly Income Shares Corporations. Instead, Mr. Kenyon caused his dummy corporation, Kenyon & Company, Incorporated, to receive $56,250 of the proceeds as a commission for effectuating the sale.[459] The remainder of the proceeds of the sale was borrowed by Kenyon & Company, Incorporated, without collateral security.[460]

By June 30, 1936, five months after Mr. Kenyon had acquired control of the company, Monthly Income Shares, Inc., of New Jersey had total assets of $171,553.[461] Of this sum, $122,225 represented the indebtedness to the corporation of Kenyon & Company, Incorporated.[462] The total value of the company's portfolio of listed securities and its cash constituted less than 19% of its total assets, instead of 50% as required by the company's charter.[463]

As at July 31, 1936, Monthly Income Shares, Inc., of New York's total assets of $225,836.09 [464] included $187,616.83 as loans and accounts receivable from companies and individuals dominated by Mr. Kenyon.[465] Only $31,337.64, or 13.87% of the company's total assets, consisted of cash and listed securities, instead of 50% as required by the charter of this company.[466]

In October 1936, both of the Monthly Income Shares companies were restrained by the New York Supreme Court from doing business and from further distribution of their securities, on the application of the Attorneys General of New York and New Jersey acting under the "Blue Sky" laws of their respective states.[467] Finally,

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[456] Op. cit. supra, note 431, at 20003, et seq., and Commission's Exhibits Nos. 3081, 3082.

[457] Id., at 19501–2.

[458] Id., Commission's Exhibits Nos. 3075, 3076.

[459] Id., at 19608–10.

[460] Ibid.

[461] Id., Commission's Exhibit No. 3083.

[462] Ibid. In addition, the assets represented $2,500 due from Grantham and Winans, $4,200 from National Associated Dealers, Inc., $9,973 from Lancaster, Havens & O'Brien, Inc., and $138,898 due from other corporations or individuals dominated by the Kenyons. (Ibid.)

[463] Op. cit. supra, note 435.

[464] Op. cit. supra, note 431, Commission's Exhibit No. 3162.

[465] Ibid.

[466] Op. cit. supra, note 435.

[467] Op. cit. supra, note 431, at 19823 and 19993; *David Wilentz, Attorney General, etc.*, v. *Monthly Income Shares, Inc., et al.,* Chancery 115–349. (Derived from supplementary information supplied the Commission for Investors Fund of America, Inc.—letters to the Commission from the Attorney General of New Jersey dated May 23, 1938, and February 27, 1939.) At or about the same time an investigation of the affairs of Monthly Income Shares, Inc., of New York was being conducted by the Attorney General of New York (op. cit. supra, note 431, at 19824, 20059, 20063f, and 20070). Upon application of the Attorney Gen-

both companies were placed in receivership for liquidation.[468] Mr. Kenyon, the record indicates, repaid $40,000 of his indebtedness to the New York company.[469] The record does not indicate what restitution, if any, Mr. Kenyon made to the New Jersey company.

f. Sterling Securities Corporation—Atlas Corporation

Sterling Securities Corporation was incorporated in Delaware on February 18, 1928,[470] under the sponsorship of Edward B. Twombly, an attorney, Sterling Pile, the president of Insuranshares Corporation of New York, and Walter R. Wolf, the assistant to the president of The Farmers' Loan & Trust Company.[471]

The charter of the corporation restricted its investments in any one security or in the securities of any one company to an amount not exceeding 5% of the assets of the corporation. In addition, investing in securities involving double liability, that is, investment in bank stocks, was forbidden. Finally, no part of the assets of the corporation was to be invested in securities for "the purpose of acquiring, controlling, or carrying on the whole or any part of the business of any corporation * * * or other organization issuing such securities." [472] This restriction prevented any attempt upon the part of Atlas Corporation, after it acquired control of Sterling Securities Corporation, to use its assets for the furtherance of Atlas Corporation's acquisition program.

The authorized capital structure of the corporation consisted of 500,000 shares of convertible first preferred stock of the par value of $50 a share, entitled on dissolution of the corporation to a prior preference in assets to the extent of $50 a share and accrued dividends, and convertible within a specified period of time into Class A common stock in a specified ratio; 500,000 shares of preference stock of the par value of $20 a share and entitled on dissolution to $20 a share and accrued dividends; 1,350,000 shares of Class A common stock without par value, entitled on dissolution in preference to the Class B common stock to $12 a share and accrued dividends and thereafter to 75% of the remaining assets of the corporation; and 300,000 shares of Class B common stock without par value. The preferred and preference stocks were entitled to cumulative dividends at the rate of 6% per annum; the Class A common stock was entitled

eral of New York, an order was issued by the Supreme Court of the State of New York on September 16, 1936, restraining the alienation of any of the corporation assets, and a further order to the same effect was issued by the same court on December 12, 1936 (id., at 20070–1).

[468] Id., at 19823 and 19973 and letter to the Commission from Attorney General of New Jersey, dated May 23, 1938. Donald P. Kenyon died on December 27, 1938. On March 30, 1939, various individual associates of Mr. Kenyon were indicted by the Federal Grand Jury for the Southern District of New York on account of their activities and transactions with the Monthly Income Shares companies and other investment companies.

[469] Op. cit. supra, note 431, at 20066. On September 2, 1936, Mr. Kenyon caused Monthly Income Shares, Inc., of New York to accept 350 shares of stock of North Bergen Trust Company at $115 per share, for a total of $40,250, in partial discharge of the indebtedness then due that corporation from Kenyon & Company, Incorporated (ibid.).

[470] Public Examination, Sterling Securities Corporation, at 14628 and Commission's Exhibit No. 1496.

[471] Id., at 14631–3, and the reply to the Commission's questionnaire for Sterling Securities Corporation, Pt. I.

[472] Op. cit. supra, note 470, Commission's Exhibit No. 1496.

to a cumulative dividend of 84 cents per annum and to 75% of any earnings after prior dividend requirements, the remaining 25% accruing to the Class B stock. The design of the capital structure was to grant to the Class B common stock 25% of the corporate earnings after payment of 6% per annum upon all senior securities.[473]

The preferred and preference stocks had no voting privileges except upon the default in payment of four consecutive quarterly dividends in which event the stock acquired one vote a share for all corporate purposes. The Class A common stock had one vote a share for all corporate purposes. The Class B shares had one vote a share for all corporate purposes other than the election of directors. For the election of directors each Class B common share was entitled to as many votes as there were directors to be elected. Since the initial by-laws of the corporation provided for 22 directors, each Class B share was entitled to 22 votes in the election of directors. However, upon the happening of the contingency—default on four consecutive dividends—which entitled the preferred and preference stock to voting privileges, the Class B common stock's cumulative voting privileges were to be terminated. In such event the Class B stock was to be entitled to only one vote a share.[474]

With the exception of the Class B stockholders who were granted a preemptive right to purchase all future issues of Class B stock, the common law preemptive right of the stockholder to purchase additional newly authorized shares of the corporation's stock was eliminated by express charter provision. The charter further strengthened the control of the corporation by Class B common stockholders by requiring the consent of at least 75% of the Class B stockholders to any increase in the number of Class B shares authorized by the charter of the corporation.[475]

As will be seen below, of a total of 298,297 Class B common shares which were issued by the corporation, all but 50,000 of such shares were acquired by the directors, officers, and managers of Sterling Securities Corporation.[476] The stock was intended to be "management stock" and was to serve as permanent management compensation. However, nothing except each individual's "own feeling of responsibility"[477] restrained the recipients of the stock from disposing of it at any time.

On March 3, 1928, the corporation issued at a price of 50 cents a share, 28,333 shares of its Class B common stock to Sterling Pile, 28,333 shares of the same stock to Walter R. Wolf, and 28,333 shares to Edward B. Twombly.[478] On the same day, a contract was entered into between Sterling Securities Corporation and Insuranshares Corporation of New York whereby the latter agreed to become the exclusive selling agent for the securities of Sterling Securities Corporation and also agreed to purchase 30,000 shares of the corporation's Class B common stock at a price of 50 cents a share. However, the issuing corporation was to have the right to repurchase such Class B

[473] Ibid.
[474] Ibid.
[475] Ibid.
[476] Op. cit. supra, note 385, Commission's Exhibit No. 2001 (pp. 259–60).
[477] Op. cit. supra, note 470, at 14645.
[478] Id., at 14666.

shares on the failure of Insuranshares Corporation of New York to sell a prescribed amount of Sterling Securities Corporation securities.[479]

On March 3, 1928, a contract was also entered into with Harold A. Fortington who agreed to serve on the corporation's finance committee and to subscribe to 30,000 shares of the corporation's Class B common stock at a price of 50 cents a share. The contract was terminable at will by either party on 30 days' notice, but if the contract were terminated Mr. Fortington was to resell his Class B common stock to the corporation at a price to be agreed upon by the parties.[480]

On the same day, an agreement was also consummated with Scudder, Stevens & Clark, a firm of investment counselors, under the terms of which Theodore T. Scudder was to serve on the corporation's finance committee and the firm was to manage the corporation's portfolio investments for an annual fee of 1/4 of 1% of the assets per annum. The firm of Scudder, Stevens & Clark also agreed to purchase 30,000 shares of the corporation's Class B common stock at the price of 50 cents a share. In this case, also, the agreement was terminable at will by either party, but on termination of the agreement the 30,000 shares of Class B common stock were to be repurchased by the corporation at a price to be determined by the parties.[481]

In sum, a total of 174,999 shares of the Class B common stock of Sterling Securities Corporation, more than a majority of the number of such shares authorized by the corporation's charter, were issued to these above-named organizers and sponsors of the corporation for a total consideration of $87,499.50.[482]

During 1928 and 1929, a total of 28,298 shares of Class B stock were issued at the price of 50 cents a share to other directors and officers of the corporation.[483]

Early in March 1928, Sterling Securities Corporation sold privately to so-called Founder Subscribers a total of 250,000 shares of its preference stock, 250,000 shares of its Class A stock, and 50,000 shares of its Class B common stock, in units consisting of five shares of preference stock, five shares of Class A common stock and one share of Class B common stock at a price of $160.50 a unit. No commissions were paid on these sales, and the corporation received as consideration for the issuance of these shares a total of $8,025,000.[484]

In May 1928, Insuranshares Corporation of New York offered to the public 250,000 units of Sterling Securities Corporation securities at $34 a unit, each unit consisting of one share of preference stock and one share of Class A common stock. Sterling Securities Corporation received a net of $32 for each unit and on the sale of these securities received a total consideration of $8,000,000.[485]

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[479] Id., Commission's Exhibit No. 1497.

[480] Id., Commission's Exhibit No. 1510.

[481] Id., Commission's Exhibit No. 1509.

[482] Id., at 14649, 14654.

[483] Op. cit. supra, note 385, Commission's Exhibit No. 2001 (pp. 260–1).

[484] Op. cit. supra, note 470, at 14653–4.

[485] Id., at 14654–5. Insuranshares Corporation of New York received a gross selling commission of $2 a unit, or a total of $500,000 (id., at 14656).

At the conclusion of this financing, Sterling Securities Corporation had received, in consideration of the issuance of 500,000 shares of its preference stock, 500,000 shares of its Class A common stock, and 273,297 shares of its Class B common stock, a total of $16,136,-648.50.[486] Of this total capital contribution, the corporation's sponsors, officers, directors, investment managers, and its selling agent held a total of 223,297 shares of the Class B common stock for which they had paid 50 cents a share, or a total of $111,648.50. As has been indicated, this stock with its cumulative voting privilege controlled the management and investment of in excess of $16,000,000 of funds contributed to the corporation by the investing public.

However, the corporation had not yet disposed of any of its first convertible preferred stock. As a preliminary to the sale of this stock, it was determined by the Corporation's directors to attempt to have the corporation's securities, with the exception of the Class B common stock, listed upon the New York Stock Exchange. Mr. Twombly contacted Charles Hayden, of Hayden, Stone & Co., in an effort to obtain his aid in securing the listing upon the New York Stock Exchange of the securities of Sterling Securities Corporation. Mr. Twombly also desired the aid and participation of Hayden, Stone & Co., in the contemplated marketing of the first convertible preferred stock of Sterling Securities Corporation.[487]

On May 21, 1929, Hayden, Stone & Co. entered into an agreement with Sterling Securities Corporation by the terms of which Steele Mitchell and Charles Hayden, partners of Hayden, Stone & Co., were to become directors of Sterling Securities Corporation and Steele Mitchell was to serve on the executive and finance committees of the corporation.[488] Hayden, Stone & Co. also agreed to assist Insuranshares Corporation of New York in the contemplated marketing of the first preferred stock of Sterling Securities Corporation.

In consideration of these commitments upon the part of Hayden, Stone & Co., Sterling Securities Corporation sold to Hayden, Stone & Co., 100,000 shares of its authorized but unissued Class A common stock at $12 a share and 25,000 shares of its authorized but unissued Class B common stock at the price of 50 cents a share. It was the understanding of the directors of Sterling Securities Corporation that these shares were taken by Hayden, Stone & Co. as a permanent investment.[489]

The 100,000 shares of Class A stock purchased by Hayden, Stone & Co. for $12 a share had a then asset value of $15 a share and a market value, in June 1929, ranging from $25⅜ to $28⅜.[490]

Apparently, Hayden, Stone & Co. did not share the understanding of the directorate of Sterling Securities Corporation that the firm was acquiring the securities of the corporation for permanent investment. The firm promptly proceeded to dispose of the 100,000 Class A shares which it had acquired from the corporation. In July 1929, it sold 50,000 shares of the stock to The Adams Express Company, an investment company managed by the firm, at a price of $16 a

[486] Id., at 14657.
[487] Id., at 14668, and Commission's Exhibit No. 1498.
[488] Id., Commission's Exhibit No. 1498.
[489] Id., at 14671, 14674.
[490] Id., at 14672.

share, or at a profit of $200,000, and sold the remaining 50,000 shares to its customers and in the open market. The total profit derived by Hayden, Stone & Co. from its disposition of the 100,000 shares of the Class A common stock of Sterling Securities Corporation, was $470,000.[491]

In addition, Hayden, Stone & Co. in 1929 sold in the open market, at an average price of $22 a share, 4,700 shares of the 25,000 shares of Class B common stock of the corporation which it had purchased for 50 cents a share. On these sales the firm realized a profit of $101,050. Of the firm's remaining holdings of Class B stock, 17,300 shares were conveyed to The Adams Express Company and 3,000 shares were retained by the firm.[492]

The contact with Sterling Securities Corporation brought other benefits to Hayden, Stone & Co. From 1929 to 1931, when Atlas Corporation acquired control of Sterling Securities Corporation, the firm received an estimated total of $129,118.78 in brokerage commissions from Sterling Securities Corporation. And on the distribution of the corporation's first preferred stock in September 1929, Hayden, Stone & Co. derived selling commissions of $48,000.[493]

In July 1929, the New York Stock Exchange admitted to trading the preference and Class A common stock of Sterling Securities Corporation. However, as a condition of listing of these securities, the New York Stock Exchange demanded the elimination of the cumulative voting privileges of the Class B common stock of the investment company.[494] Apparently, the stock exchange objected to the control of $16,000,000 of public funds by those whose contribution to the enterprise, represented by the 298,297 outstanding shares of the Class B common stock, totaled only $149,148.50.

On September 9, 1929, Hayden, Stone & Co. and Insuranshares Corporation of New York offered to the public 300,000 shares of the first convertible preferred stock of Sterling Securities Corporation at a price of $54 a share. The corporation on this issuance of its securities, received a total of $15,000,000, that is, $50 for each share of its first preferred stock issued. Hayden, Stone & Co. and Insuranshares Corporation of New York received a gross selling commission of $4 a share, or $1,200,000 for the sale of the entire issue.[495] However, the bulk of the shares were sold by Insuranshares Corporation of New York. Hayden, Stone & Co., which, as has been described, was enabled to make large profits as a result of its contact with Sterling Securities Corporation, a contact which was established partly because of the belief of Sterling Securities Corporation's directors that the firm could be of material assistance in the distribution of the first preference stock, sold less than $1,000,000 of the first preferred stock.[496]

At the conclusion of this final financing by Sterling Securities Corporation, it had acquired from the issuance of its securities a total of $32,475,898.50.[497] In return for this fund the corporation as at De-

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[491] Id., at 14677.

[492] Id., at 14678 and derived from supplementary information supplied the Commission for Sterling Securities Corporation.

[493] Op. cit. supra, note 470, at 14678.

[494] Id., at 14659.

[495] Id., at 14661–2.

[496] Id., at 14674.

[497] Id., at 14662.

cember 31, 1929, had issued 297,465 shares of its first preferred stock, 500,000 shares of its preference stock, 603,802 shares of its Class A common stock, and 298,297 shares of its Class B common stock.

The management of the corporation thus was ultimately furnished with approximately $32,000,000 of the public's funds to be invested. Yet, the net capital contribution of the management to the enterprise did not exceed $149,148.50. Although the Class B common stock, following the listing of the corporation's other securities upon the New York Stock Exchange, was deprived of its cumulative voting privileges so that it no longer controlled the election of the company's directors, yet it had substantial possibilities for appreciation in value due to the leverage afforded it by the senior securities. As has been pointed out, the Class B common stock was entitled to 25% of all the corporation's profits and of the appreciation in value of the corporation's assets after payment of the prior fixed claims of the senior securities. Essentially, the managers, on a payment of approximately $150,000 for their stock, had the use of $32,000,000 of other people's money with which to speculate upon an enhancement in value of their own interest in the corporation.

Walter R. Wolf, one of the organizers of the corporation, admitted in his testimony that the effect of the capital structure was to enable the "insiders" and managers of the corporation to acquire the privilege of operating a margin account with $32,000,000 of the public's funds without taking any risk other than the virtually nominal cost of the Class B common shares held by them. Mr. Wolf testified:[498]

Q. In any event, if we can analogize, it was as if the insiders, the people who had the management stock, had an interest in a margin account with a brokerage firm of $32,000,000 when their contribution was $174,000 and they got a cut of 25% of the profits after allowing the people who put in the $32,500,000, six percent, isn't that so?

A. Yes, I think substantially so.

In fact, the corporation's investment policy, as determined by its management, was to capitalize upon the high leverage given to the Class B stock of the corporation by the $32,000,000 of senior securities, by concentrating in the most speculative of securities—common stocks. As at December 31, 1928, 95% of the corporation's portfolio, which totaled at cost $10.562,417.91, consisted of common stocks. The $15,000,000 raised by the sale of the first preferred stocks of the corporation in September 1929 was substantially entirely invested in common stocks by December 31, 1929. As at December 31, 1929, virtually the entire $32,000,000 which the corporation had received was so invested. The corporation had, as at December 31, 1929, cash and call loans of $5,626,003.59 as compared with security investments costing $29,740,785.92. Common stocks totaled 95% of the corporation's investments.[499]

Even after the collapse in the market values of securities in October 1929, the corporation maintained a portfolio topheavy with common

[498] Id., at 14710.

[499] Id., Commission's Exhibits Nos. 1512, 1514.

stocks. As at December 31, 1930, 97% of the corporation's portfolio consisted of common stocks.[500]

In September 1930, Harold A. Fortington, because of his investment views and his "personality," [501] was requested to resign from the finance committee and the board of directors of Sterling Securities Corporation. Mr. Fortington complied with the request and resigned September 9, 1930. Sterling Securities Corporation repurchased from Mr. Fortington 10,000 of his 30,000 shares of its Class B common stock at a price of $5 a share, or a total of $50,000.[502] On this transaction Mr. Fortington made a profit of $45,000.[503] Sterling Securities Corporation immediately sold the 10,000 shares at $5 a share, its own cost, to American Founders Corporation. George E. Devendorf, a vice president of American Founders Corporation, was elected a director and a member of the finance committee of Sterling Securities Corporation.[504]

Scudder, Stevens & Clark were sharply opposed to the participation of American Founders Corporation in the management of Sterling Securities Corporation. They disagreed sharply with the investment policies of that corporation.[505] On October 9, 1930 Scudder, Stevens & Clark terminated their management contract with Sterling Securities Corporation, and the latter repurchased from Scudder, Stevens & Clark at $1 a share 20,000 shares of the 30,000 shares of Class B stock which they held.[506] Thus, on this, Scudder, Stevens & Clark derived a profit of $10,000, since that firm had originally paid 50 cents a share for their stock. During their tenure as managers of Sterling Securities Corporation, Scudder, Stevens & Clark derived management fees totaling $149,051.31.[507]

The Class B shares repurchased from Scudder, Stevens & Clark by Sterling Securities Corporation were resold to American Founders Corporation at their cost to Sterling Securities Corporation.[508]

Sterling Securities Corporation, from 1930 to July 1931, expended in the repurchase of its securities and distributed as dividends a total of $3,977,216.37. If these amounts expended in repurchases of stock and in dividends be deducted from the total capital of $32,349,148.50 contributed to the corporation, the net capital contributed to the enterprise was $28,371,932.13. As at July 31, 1931, when Atlas Corporation acquired control of the corporation, its net worth was $16,764,854.72.[509] In other words, the corporation had suffered a shrinkage in assets of $11,607,077.41, the equivalent of 42% of its net contributed capital. Mr. Scudder, of Scudder, Stevens & Clark readily admitted that the losses suffered by Sterling Securities Cor-

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[500] Id., Commission's Exhibit No. 1512.

[501] Id., at 14745.

[502] Op. cit. supra, note 385, Commission's Exhibit No. 2001 (p. 261).

[503] These shares were originally purchased by Mr. Fortington at 50 cents a share.

[504] Op. cit. supra, note 385, Commission's Exhibit No. 2001 (p. 261) and op. cit. supra, note 470, at 14745 and Commission's Exhibit No. 1512.

[505] Op. cit. supra, note 470, at 14778–9.

[506] Id., at 14763–4 and Commission's Exhibit No. 1511. The balance of the 10,000 shares held by Scudder, Stevens & Clark was purchased from the firm by Mr. Fortington at $3 a share (ibid.). It constituted some of the stock which Mr. Fortington was accumulating for Atlas Corporation. (See infra, pp. 1169–70.)

[507] Op. cit. supra, note 470, at 14766.

[508] Op. cit. supra, note 385, Commission's Exhibit No. 2001 (p. 261).

[509] Id., Commission's Exhibits Nos. 2003, 2043.

poration were directly attributable to the corporation's concentration of investments in common stocks.[510]

As at July 31, 1931, Sterling Securities Corporation had outstanding 278,865 shares of its first preferred stock, which had an asset value of $50 a share but was selling in the market at $35 a share; 500,000 shares of preference stock with an asset value of $5.64 a share and a market value of $7 a share; 603,802 shares of Class A stock which had no asset value but a market value of $3; and 298,297 shares of Class B common stock which had no asset value and no quoted market value.[511]

Early in April 1931, B. K. Seely introduced Harold A. Fortington, who, as has been indicated, had resigned as a director and member of the finance committee of Sterling Securities Corporation in September 1930, to the officers of Atlas Corporation.[512] Apparently, an agreement was entered into between Mr. Fortington and Atlas Corporation by which Mr. Fortington was to aid Atlas Corporation in its efforts to acquire a controlling block of the Class B common stock of Sterling Securities Corporation. At any rate Mr. Fortington eventually received from Atlas Corporation a commission of $20,000 for his services in behalf of Atlas Corporation. Mr. Seely was paid a fee of $40,000 by Atlas Corporation for his services in "finding" Sterling Securities Corporation for Atlas Corporation.[513]

The objective of Atlas Corporation was to profit by purchasing the preferred and preference stocks of Sterling Securities Corporation at their market price which, as has been seen, was substantially below the asset value of these shares. However, the holders of the Class B shares, which represented only one-third of the total voting stock (the Class A shares which had voting rights totaled 603,802 shares as compared with 298,297 shares of outstanding Class B stock), nevertheless were the managers of the corporation. In addition, they presumably had a large influence and prestige with the stockholders of the corporation. Consequently, in order to gain control of the management of the portfolio of Sterling Securities Corporation, it was necessary for Atlas Corporation to purchase the Class B shares of Sterling Securities Corporation. The purchase of their shares would also eliminate the pecuniary interest of the corporation's management in the corporation and thus make it unlikely that they would oppose Atlas Corporation in its future program of acquisition of the preferred and preference stocks for a consideration less than their actual asset value.

As has been indicated, the Class B shares were awarded to the directors, officers, and managers of the corporation at the nominal price of 50 cents a share as a compensation for their management of the corporation. The stockholders of the corporation were informed in the prospectus offering the stock of the corporation that "Compensation of management comes through ownership of B common stock which is being subscribed for by the Founder Subscribers,

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[510] Op. cit. supra, note 385, at 14758–9.

[511] Op. cit. supra, note 385, Commission's Exhibit No. 2043, and *Bank and Quotation Record,* July 1931.

[512] Derived from supplementary information supplied the Commission for Atlas Corporation.

[513] Op. cit. supra, note 385, at 17792.

Directors, the Investment Committee, Selling Group Managers, etc., * * * In brief, the investor receives a 6% return, if earned, before the Management participates, and a community of interest is established whereby the managers must make the holdings of the Senior Stockholders profitable before they receive any compensation through their B stockholdings." [514]

Stockholders presumably accepted this means of compensation to their management on whose investment ability they presumably relied. Possibly, they also felt that the Class B stock was taken by the management for permanent investment. At least some of the directors had this belief. Thus, Mr. Scudder of Scudder, Stevens & Clark testified that his impression was that all of the Class B stock was purchased by the directors and officers as a continuing management compensation and that the shares could be sold only to the corporation itself. His agreement with the corporation under which he purchased the shares so provided.[515]

In fact, there were no restrictions upon the sale of the Class B stock held by the directors and officers of the corporation other than the restriction in the contracts between Scudder, Stevens & Clark and Harold A. Fortington, respectively,[516] both of whom resold to the corporation, on their retirement as directors and managers of the corporation, such portion of their Class B shares as the corporation was willing to purchase. Other directors, however, availed themselves of an opportunity to profit by the sale of their Class B stock in the open market during 1928 and 1929 when, because of the high leverage factor in favor of the Class B stock, it sold at prices as high as $20 a share. As has been indicated, the cost of those shares to the directors was 50 cents a share. Hayden, Stone & Co., as has already been indicated, disposed of 4,700 shares of Class B stock in 1929 at a profit of $101,050. Walter R. Wolf, one of the organizers of the corporation, who on March 3, 1928 received 28,333 shares of Class B stock at 50 cents a share, almost immediately proceeded to dispose of a large portion of the shares in the open market. Mr. Wolf, and the trustees of trusts created by him for the benefit of his relatives, sold a total of 18,875 shares of Class B stock in the open market at prices as high as $20 a share for a total profit of $223,981.18.[517]

To return to Atlas Corporation's efforts to acquire control of Sterling Securities Corporation, it has been shown that Harold A. Fortington was retained to effect sales of Class B stock to Atlas Corporation. The first holder of Class B stock whom Mr. Fortington saw was Mr. Wolf. As a result of this contact, Mr. Wolf and his relatives sold to Atlas Corporation their remaining holdings of Class B stock—9,458 shares—at a price of $5 a share. Mr. Wolf derived a profit on these shares of $42,561, thus increasing his total profit on the disposition of his entire 28,333 shares of Class B stock to $266,542.18.[518]

On May 14, 1931, Mr. Fortington purchased for Atlas Corporation's account from Scudder, Stevens & Clark, their remaining holdings of 10,000 shares of Class B stock at a price of $3 a share, or a

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[514] Op. cit. supra, note 470, Commission's Exhibits Nos. 1503, 1513.

[515] Id., at 14763 and Commission's Exhibit No. 1509.

[516] Id., Commission's Exhibit No. 1510.

[517] Id., at 14695–6.

[518] Ibid.

profit to Scudder, Stevens & Clark of $25,000.[519] The total profit to Scudder, Stevens & Clark on the sale of their entire 30,000 shares was $35,000. Atlas Corporation purchased 4,000 shares of Class B stock from Daniel Pierce, a director of Sterling Securities Corporation, at prices of $3 and $5 a share; 3,000 shares were purchased by Atlas Corporation from Robert Pomeroy, another director of Sterling Securities Corporation, at a price of $4 a share.[520]

On June 30, 1931 Atlas Corporation purchased 3,000 shares of Sterling Securities Corporation Class B stock from Hayden, Stone & Co. at a price of $3 a share, and 17,300 shares of the same stock from The Adams Express Company, an investment company managed by Hayden, Stone & Co., at a price of $4 a share.[521] Hayden, Stone & Co. on its sale realized a profit of $7,500. The profit to The Adams Express Company totaled $60,550. All of these shares had been acquired originally by Hayden, Stone & Co. at a price of 50 cents a share.

By the middle of July 1931, Atlas Corporation had accumulated a total of 61,763 shares of the Class B stock of Sterling Securities Corporation, or approximately 21% of the 298,297 shares of the Class B common stock then outstanding, at a total cost of $253,479.[522] The sellers of these shares, on the basis of their original cost of 50 cents a share, had realized a profit of $222,597.50.

In the middle of July 1931, Charles Hayden, of Hayden, Stone & Co., informed other individuals connected with the management of Sterling Securities Corporation, that is, Sterling Pile, American Founders Corporation and Allied General Corporation (the former Insuranshares Corporation of New York), that Atlas Corporation had control or would shortly acquire control of Sterling Securities Corporation.[523] Actually, Atlas Corporation held only 21% of the Class B stock of the corporation and virtually none of its Class A stock, the stock which actually controlled the corporation. On the other hand, those in control of Sterling Securities Corporation held 80,000 shares of the Class A stock and approximately 125,000 shares of the Class B stock, or 41% of the Class B stock then outstanding.

Sterling Pile and his associates, after receiving this information from Charles Hayden, informed Edward B. Twombly, who was away on a vacation, that "Sterling had been sold out from under us." [524] Mr. Twombly went to see Mr. Hayden and testified that he had the following conversation with Mr. Hayden: [525]

A. * * * I returned to New York immediately, met a group of the fellow directors in the New York Trust Company, and they said that they had been advised by Mr. Hayden that the control had either been already acquired or was in the process of being acquired by Atlas Corporation and that he recommended to them that they sell their holdings to the Atlas Corporation.

Q. That is, Hayden recommended to the other directors?

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[519] Op. cit. supra, note 506.

[520] Op. cit. supra, note 385, Commission's Exhibit No. 2001 (p. 262).

[521] Ibid.

[522] Ibid.

[523] See infra, p. 1172. Hayden, Stone & Co., after July 1931, received a portion of the brokerage business of Atlas Corporation (id., Commission's Exhibit No. 2001 (p. 263)).

[524] Op. cit. supra, note 470, at 14726.

[525] Id., at 14726–7.

A. That is right; and they said they wanted to include me. I immediately went over to see Mr. Hayden and said, "Is it true that you have sold your B stock?" He said, "Yes." I said, "That was not in accordance with our understanding." He said, "Whether it was or not, it has been sold," and I said, "Well, what is the situation?" He said he thought Atlas was probably now in control of the company; if not, it was very close to it. He said, "It won't do you any good trying to do anything about it now. You had better join with the other directors and dispose of your securities to them [Atlas]." I said, "I won't do it unless I can include others that I interested in the picture." So I went back and saw these directors and told them I was not prepared to make up my mind until I had gotten into contact with a great many more, and that unless Atlas was willing to include all, that the stock would not be sold. So I spent night and day for about 48 hours getting in contact with individuals who I knew had substantial blocks, most of whom included their blocks in the sale to Atlas, and the whole business was sold out to Atlas within 48 hours.

On July 17, 1931, Atlas Corporation entered into an agreement with those in control of Sterling Securities Corporation to purchase their holdings of 80,000 shares of the corporation's Class A stock at a price of $5 a share and to purchase their holdings of approximately 125,000 shares of Sterling Class B stock at a price of $4 a share.[526] Of the Class A shares so acquired by Atlas Corporation, 37,500 shares were sold by American Founders Corporation, 13,000 were sold by Sterling Pile, and 21,500 were sold by Allied General Corporation, the former Insuranshares Corporation, of which Sterling Pile was both the president and a director. The 125,000 shares of Class B stock thus acquired by Atlas Corporation included sales by American Founders Corporation of 24,700 shares; by Sterling Pile of 11,325 shares; by Allied General Corporation of 27,300 shares; by Insuranshares & General Management Company, with which Sterling Pile was affiliated, of 6,200 shares; by Edward S. Goodwin, a director of Sterling Securities Corporation, of 6,600 shares; and by Edward B. Twombly and his associates of 17,075 shares.[527] On the basis of 50 cents a share, or the original cost of these shares, these sellers derived a profit on their Class B shares of $437,500.

The purchase price paid by Atlas Corporation for the Class A shares was $2 a share in excess of the market price. The stock had no asset value. The Class B stock had no quoted market and no asset value.[528]

By December 31, 1931, Atlas Corporation had accumulated 210,708 shares of Sterling Securities Corporation Class B stock, or 71% of the 298,297 shares outstanding, and 86,896 shares of Sterling Securities Corporation Class A stock, or 14% of the 603,802 shares of such stock outstanding.[529] Of the total 902,099 shares of voting stock (both the Class A and Class B stock had voting rights), Atlas Corporation owned, as at December 31, 1931, only 297,604 shares, or approximately 33%, of the voting shares of Sterling Securities Corporation.

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[526] Op. cit. supra, note 385, Commission's Exhibit No. 2001 (p. 263).

[527] Op. cit. supra, note 470, Commission's Exhibits Nos. 1506, 1507.

[528] The highest market price of Sterling Securities Corporation's Class A stock in July 1931 was $4, the lowest $3 (Public Examination, Atlas Corporation, Commission's Exhibit No. 2001 (p. 266)).

[529] Op. cit. supra, note 385, Commission's Exhibit No. 2001 (pp. 266–7).

Despite the absence in Atlas Corporation of a majority controlling interest in Sterling Securities Corporation, on August 4, 1931, after the previous management of Sterling Securities Corporation had disposed of their Class A and Class B shares to Atlas Corporation, L. Boyd Hatch, E. K. Hall, O. L. Johnston, and Floyd B. Odlum, all directors of Atlas Corporation, were elected directors of Sterling Securities Corporation.[530] Thereafter, Atlas Corporation assumed actual management of the portfolio of Sterling Securities Corporation.

The preferred stockholders of Sterling Securities Corporation, who were the actual owners of the assets of Sterling Securities Corporation, were not informed of the shift in the management of their corporation until January 19, 1932, the date of the publication of the annual report of the corporation for the year ending 1931.[531] Nor were they consulted prior to the passage of control of their company to Atlas Corporation. The cessation of the pecuniary interest of their former management in the affairs of the investment company left them without any effective representation against the future Atlas Corporation program of acquiring the senior securities of the corporation at prices less than the actual asset value of such shares. Mr. Twombly admitted that this undisclosed transfer of control of Sterling Securities Corporation to Atlas Corporation was not a "healthy situation." He testified:[532]

Q. And so far as the management stock was concerned, and this is entirely apart from whether it was good or bad for the stockholders, you called up to see that they at least got the same treatment as the other B stockholders got?

A. That is right.

Q. But whether it was part of the system or because the law permitted it, there was nobody there to see that the other stockholders who put in the $32,500,000 got a certain type of treatment, was there?

A. They had no different type of treatment. They owned the senior securities.

Q. They owned the senior securities and it was their money?

A. They had nothing to say about the change in management and they were not notified of the change in management prior to its taking place.

Q. But there was nobody there at the time control was turned over to say "I won't let this thing go through unless I am sure that the people who put in the $32,500,000 get a good deal on their stock," was there?

A. No.

Q. You suddenly found yourself in a position when the new group was in there in control and according to the expression you used, the Trust was sold right from under you, isn't that so?

A. That is right. The only protection that was insisted upon was that they be advised.

Q. Well, that advice took place after it was a fait accompli?

A. Well, it was in effect, a fait accompli at the time.

Q. That is based on what you believe the facts were?

A. That is right.

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[530] Op. cit. supra, note 470, Commission's Exhibit No. 1512.

[531] Ibid.

[532] Id., at 14729–37.

Q. But whether it was a fact that Atlas had control or was about to get control you don't know?

A. No; I don't.

Q. Because you don't know what their holdings were. Did Mr. Hayden tell you that Mr. Odlum told him he had control or was about to get control, or did Mr. Hayden make it his statement of fact?

A. He made his statement.

Q. He didn't say that Mr. Odlum told him he had control or was about to get control?

A. He did not.

Q. And you don't know whether it was a fact that Mr. Odlum had control or was about to get control, do you?

A. No; I do not.

* * * * * * *

Q. This is an illustration of the lightning speed at which a transfer of funds of other people's money in the investment trust field——

A. You mean control of it?

Q. Yes.

A. Yes.

Q. Do you think that is a healthy situation?

A. I didn't.

Q. You didn't?

A. No.

Q. You probably felt some sense of obligation to these people [the holders of senior securities]?

A. I probably did.

Q. And you probably had a feeling that these people had invested this money and turned over the management of the fund to you?

A. That is why I stayed on the board of directors.

Q. You can visualize the situation back in '31 when there were some people who hadn't even heard of Atlas until this time.

A. That is right.

Q. And they wake up one morning and find themselves with their funds being administered by the Atlas * * * Company.

A. That is so.

Q. Without their expressed consent, anyway?

A. That is right.

Q. You had no disclosure as to what their future policy was going to be?

A. That is right.

Q. What disposition was going to be made of their money; how it was going to be invested?

A. That is right.

The purpose of Atlas Corporation was to acquire, either by market purchases or exchange offers, the senior securities of Sterling Securities Corporation at prices less than the asset value of such shares. As at December 31, 1931, the preference stock of Sterling Securities Corporation had no asset value. Nevertheless, the "leverage" afforded to such stock by the presence of the first preferred stock in the corporation's capital structure would augment the asset value of the preference stock more rapidly than the appreciation in the corporation's total assets. Purchases of and exchange offers for the Class A and Class B common stock of Sterling Securities Corporation were also made by Atlas Corporation since, although

these stocks after 1931 never had any asset value,[533] they had to be acquired by Atlas Corporation to provide Atlas Corporation with the statutory quantum of voting power necessary to dissolve Sterling Securities Corporation or to consolidate it with Atlas Corporation. The loss suffered by Atlas Corporation in its purchases of Class A and Class B stock of Sterling Securities Corporation was to be recouped from its profits made on the preferred and preference stock of Sterling Securities Corporation.

From 1931 to 1935 the market price of the preferred stock of Sterling Securities Corporation was markedly less than its asset value, although under Atlas Corporation's management the differential between the asset and market value of the shares steadily decreased. However, Atlas Corporation was the only substantial bidder for the stocks, and, although Atlas Corporation did not engage in manipulative practices, its bidding or failure to bid had a substantial effect on the market price of the securities of Sterling Securities Corporation. The price paid for the securities of Sterling Securities Corporation by Atlas Corporation exceeded the market prices of comparable investment company securities. The following schedule indicates the differential between the asset and market value of the preferred and preference stock of Sterling Securities Corporation at the year-ends from 1931 to 1935:[534]

Year end—	First preferred stock			Preference stock		
	Asset value plus accrued unpaid dividends	Market value		Asset value	Market value	
		High	Low		High	Low
1931	$42.99	25	16⅛	0	2	1⅜
1932	42.24	22⅛	20	0	2⅛	1⅛
1933	57.00	35	30	0.86	4	2⅝
1934	58.65	39	33	0	5⅝	4¼
1935	60.00	50½	44½	9.30	10	8

Immediately on its acquisition of control of Sterling Securities Corporation, Atlas Corporation and its subsidiaries, principally Securities Allied Corporation, Ungerleider Financial Corporation, Chain Store Stocks, Inc., National Securities Investment Company, General Empire Corporation, and Iroquois Share Corporation, commenced to make market purchases of all classes of the stock of Sterling Securities Corporation.[535] On the dissolution of these subsidiaries their holdings of Sterling Securities Corporation shares were transferred to Atlas Corporation as liquidating dividends.

Two exchange offers were made by Atlas Corporation for the securities of Sterling Securities Corporation. The first offer[536] was made on June 4, 1932, and was one of the offers made concurrently by Atlas Corporation to 12 of its controlled companies. Atlas Corpo-

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[533] Op. cit. supra, note 385, Commission's Exhibits Nos. 1970, 2001 (pp. 262, 266).

[534] Derived from the *Bank and Quotation Record* and the reply to the Commission's questionnaire for Sterling Securities Corporation, Pt. I (annual reports to stockholders 1931–1935).

[535] Op. cit. supra, note 385, Commission's Exhibit No. 2001 (p. 265, et seq.).

[536] Id., Commission's Exhibits Nos. 1970, 2001 (p. 271).

ration offered to exchange for each share of Sterling Securities Corporation first preferred stock, a unit consisting of one-third of a share of Atlas Corporation preference stock, one share of Atlas Corporation common stock, and one Atlas Corporation option warrant. For each share of Sterling Securities Corporation's preference stock there was offered one-tenth of a share of Atlas Corporation common stock and four-tenths of an Atlas Corporation option warrant. For each share of Sterling Securities Corporation's Class A common stock there was offered one-fifth of an Atlas Corporation warrant, and for each share of Sterling Securities Corporation Class B common stock there was offered one-tenth of an Atlas Corporation warrant.

The preference, Class A and Class B stock of Sterling Securities Corporation had no asset value. The Atlas Corporation offer for these stocks was substantially an offer of its warrants which had, of course, no asset value but which had a market value substantially equivalent to the market value of these securities of Sterling Securities Corporation. The offer for the preference stock of Sterling Securities Corporation, however, resulted in an asset gain to the holders of such stock since the one-tenth of a share of Atlas Corporation common stock offered for the preference shares of Sterling Securities Corporation had an asset value of 27 cents.[537]

The offer for the first preferred stock of Sterling Securities Corporation, however, resulted in a substantial gain in asset values to Atlas Corporation. The combination of Atlas Corporation securities offered for this stock had an asset value of $19.64 (a fact not revealed in the letter of offer) and a market value of $17.46. On the other hand, one share of Sterling Securities Corporation first preferred stock had an asset value of $37.35 (a fact revealed in the letter of offer) and a market value of $14.50. Consequently, a first preferred stockholder accepting the Atlas Corporation offer suffered a gross loss in assets of $17.71 but derived a gain in market value of $2.96.[538]

A. G. Becker & Co., Inc., Chicago investment bankers, were employed by Atlas Corporation on a commission basis to solicit acceptances of these offers by Illinois holders of the shares of Sterling Securities Corporation, and Hemphill, Noyes & Co., New York investment bankers, were retained to solicit acceptances of this offer by Sterling Securities Corporation stockholders in New York City, Connecticut, Massachusetts, and Vermont.[539]

As a result of the exchange offer, Atlas Corporation acquired 25,420 shares of the first preferred stock, 76,162 shares of the preference stock, 65,166 shares of the Class A common stock, and 12,572 shares of the Class B common stock of Sterling Securities Corporation. The unrealized gain in asset values to Atlas Corporation resulting from the disparity in asset values between the securities of Sterling Securities Corporation and Atlas Corporation involved in the exchange offer was $421,072.[540]

On December 12, 1932, Atlas Corporation entered into an agreement with Schoellkopf, Hutton & Pomeroy, Inc., Buffalo (New York), investment bankers, who had been one of the largest of the original distributors of the first preferred stock of Sterling Securities

[537] Id., Commission's Exhibit No. 2001 (p. 272).
[538] Ibid.
[539] Id., Commission's Exhibit No. 2036.
[540] Id., Commission's Exhibit No. 2001 (pp. 273–4).

Corporation, under the terms of which Schoellkopf, Hutton & Pomeroy, Inc., was to aid Atlas Corporation in acquiring further first preferred stock of Sterling Securities Corporation from the investors to whom Schoellkopf, Hutton & Pomeroy had originally sold the Sterling Securities Corporation first preferred stock. The contract was to expire on December 31, 1932, and the soliciting activities of Schoellkopf, Hutton & Pomeroy, Inc., were to be confined only to those territories not already covered by A. G. Becker & Co., Inc., and Hemphill, Noyes & Co. However, Schoellkopf, Hutton & Pomeroy, Inc., was to receive an "overriding" commission of 15 cents a share on each share of first preferred stock emanating from the territories covered by these other bankers. Schoellkopf, Hutton & Pomeroy, Inc., was to receive $1.15 for each share of Sterling Securities Corporation first preferred stock which they succeeded in acquiring by exchange offer for Atlas Corporation's account. The vital provisions in the contract between Atlas Corporation and Schoellkopf, Hutton & Pomeroy, Inc., were as follows: [541]

> We [Schoellkopf, Hutton & Pomeroy, Inc.] understand we may offer two-thirds of a share of Atlas Corporation Preference stock for each share of Sterling First Preferred stock or if unable to effect an exchange will endeavor to purchase the Sterling at $1.00 below the market value of said Atlas Corporation Preference stock as hereinbefore mentioned.
>
> * * * * * * *
>
> We also understand that if desired we may offer a combination of Atlas securities of the same market value as said two-thirds of a share of Atlas Corporation Preference stock based on the closing prices on the New York Curb of the day previous to that on which the Sterling First preferred stock to be exchanged is received by you.
>
> * * * * * * *
>
> In the event that we are unable to effect the exchange of Atlas Corporation Preference Stock for Sterling First Preferred stock held by the investor, we will endeavor to buy his stock for cash, paying him $1.00 per share below the market value of the two-thirds of a share of Atlas preference stock. On this cash basis to the extent handled off the New York Stock Exchange, you will allow us 65¢ per share of Sterling First preferred stock of which we reallow dealers 40 cents.
>
> * * * * * * *
>
> In the event that we are unable to effect the exchange of Sterling First Preferred stock for Atlas Preference stock or buy it direct for cash, as stated above, it might be possible for us to recommend and accomplish the sale of Sterling First Preferred stock on the New York Stock Exchange and it presumably, therefore, will come into your [Atlas] hands. On Sterling First Preferred stock as you are about to acquire, that is your long balance as a result of your trading on the New York Stock Exchange in Sterling First Preferred stock on said exchange during the period during which the provisions hereof are in effect, you will allow us 25¢ a share.

On December 17, 1932, Schoellkopf, Hutton & Pomeroy, Inc., in a circular letter [542] addressed to the holders of the first preferred stock of Sterling Securities Corporation, offered to exchange two-thirds of a share of Atlas Corporation preference stock for each share of the first preferred stock of Sterling Securities Corporation. The offer

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[541] Id., Commission's Exhibit No. 2036.
[542] Id., Commission's Exhibits Nos. 1970, 2001 (pp. 276–7).

did not reveal the fact that commissions were to be paid to Schoellkopf, Hutton & Pomeroy, Inc. for its services by Atlas Corporation. The letter stated that a cash offer would be made to those stockholders who did not desire to exchange their stock.

The asset value of the first preferred stock of Sterling Securities Corporation was $42.24 a share as against an asset value of $33.33 for the two-thirds of a share of Atlas Corporation preference stock. These asset values were revealed in the offer.[543] Stockholders of Sterling Securities Corporation who accepted the offer suffered a gross loss in assets of $8.91. However, the market value of the Atlas Corporation preference stock offered was $22.66 as compared with a market value of $20 for the Sterling Securities Corporation first preferred stock.

Schoellkopf, Hutton & Pomeroy, Inc. and its associated dealers succeeded in purchasing for Atlas Corporation's account a total of 698 shares of Sterling Securities Corporation preferred stock. They also induced the exchange of 1,600 shares of such stock and received commissions of 25 cents a share on 1,550 shares of the stock purchased by Atlas Corporation on the New York Stock Exchange during the period of the operation of the contract between Atlas Corporation and Schoellkopf, Hutton & Pomeroy, Inc.[544] Schoellkopf, Hutton & Pomeroy, Inc. also received an overriding commission of 15 cents a share on 1,567 shares of Sterling Securities Corporation preferred stock which were exchanged by stockholders in territories under the jurisdiction of A. G. Becker & Co., Inc. and Hemphill, Noyes & Co.[545] In all, Schoellkopf, Hutton & Pomeroy, Inc. received commissions of $2,916.25 [546] on a total of 5,415 shares of Sterling Securities Corporation first preferred stock purchased or acquired by Atlas Corporation by an exchange of its securities during the operation of the contract of December 12, 1932.

The exchange offer made by Schoellkopf, Hutton & Pomeroy, Inc. was the last offer made by Atlas Corporation for the shares of Sterling Securities Corporation. Thereafter, Atlas Corporation and its controlled companies continued to accumulate Sterling Securities Corporation stock of all classes by direct open-market purchases.

As at December 31, 1935, Atlas Corporation and Atlas Utilities & Investors Company, Ltd., held the following shares of the stock of Sterling Securities Corporation: [547]

Company	Number of shares			
	First preferred	Preference	Class A common	Class B common
Atlas Corporation	159, 751	2, 650	191, 859	80, 688
Atlas Utilities & Investors Co., Ltd	17, 000	305, 974	84, 000	183, 000
Total number of shares	176, 751	308, 624	275, 859	263, 688
Percent of outstanding shares	75. 03	61. 72	45. 69	88. 40

[543] Id., Commission's Exhibit No. 2001 (p. 270).
[544] Id., Commission's Exhibits Nos. 2001 (p. 277), 2036.
[545] Id., Commission's Exhibit No. 2036.
[546] Id., Commission's Exhibit No. 2001 (p. 277).
[547] Ibid.

The total cost of these securities to Atlas Corporation and its controlled companies, after eliminating all intercompany transactions, was $7,546,338.58.[548]

Between January 1, 1936, and October 31, 1936, Sterling Securities Corporation paid in current dividends and in removal of arrearages of dividends the sum of $12 in cash on each share of its first preferred stock then outstanding. On the 176,751 shares held as at December 31, 1935 by Atlas Corporation and Atlas Utilities & Investors Company, Ltd., there was paid the sum of $2,121,012.[549]

As of October 31, 1936, when Sterling Securities Corporation was consolidated with Atlas Corporation, the total asset value of the Sterling Securities Corporation stock held by Atlas Corporation and Atlas Utilities & Investors Company, Ltd., was $14,583,003.42.[550] By adding to this sum the dividends of $2,121,012 distributed to Atlas Corporation and Atlas Utilities & Investors Company, Ltd. on their holdings of first preferred stock, the total value of the investment of Atlas Corporation and Atlas Utilities & Investors Company, Ltd., in the shares of Sterling Securities Corporation as at October 31, 1936, was $16,704,015.42. Deducting from this figure the cost ($7,546,338.58) to Atlas Corporation on the holdings of itself and of its Canadian subsidiary in all classes of the stock of Sterling Securities Corporation, the profit to these corporations on their investment in Sterling Securities Corporation stock as at October 31, 1936, was $9,157,676.84. Although this profit was in large part a result of the appreciation in value of the assets of Sterling Securities Corporation under the management of Atlas Corporation, a substantial portion of this profit represented the asset value gains derived by Atlas Corporation on its purchases of, and exchange offers for, the securities of Sterling Securities Corporation.

On September 28, 1936 Atlas Corporation, Sterling Securities Corporation, Pacific Eastern Corporation, and Shenandoah Corporation entered into an agreement of consolidation.[551] This agreement was approved by the required statutory number of stockholders of Sterling Securities Corporation on October 29, 1936. Atlas Corporation and its subsidiary, Atlas Utilities & Investors Company, Ltd., themselves held a sufficient number of shares to ratify the consolidation. Stockholders of Sterling Securities Corporation received securities of the new Atlas Corporation having an asset value approximately equal to those of Sterling Securities Corporation.[552]

g. North and South American Corporation—Insurance Equities Corporation

North and South American Corporation was incorporated in Delaware on February 21, 1929, under the sponsorship of Baker, Kellogg & Co., Inc., a Philadelphia investment banking house,[553] A. G. Becker & Co., Inc., a Chicago investment banking firm, and American

[548] Ibid.

[549] Ibid.

[550] Ibid.

[551] Id., Commission's Exhibit No. 1944.

[552] Derived from supplementary information supplied the Commission for Atlas Corporation.

[553] Public Examination, American General Corporation et al., at 26570; and *Poor's Fiscal Volume*, 1934, p. 2814.

Founders Corporation, one of the constituent companies in the so-called United Founders Corporation group of investment companies.[554] The authorized capitalization of the company consisted of a Class A stock entitled to a preference in the corporate assets on liquidation of the company to $29 a share, and a Class B stock. Each class of stock was entitled to one vote per share.[555]

On May 14, 1929, A. G. Becker & Co., Inc., Baker, Kellogg & Co., Inc., and American Founders Corporation agreed to purchase or to find purchasers for 250,000 shares of the Class A stock of North and South American Corporation at a price of $36 a share, of which $3.50 a share was to be retained by the three underwriters as their commission for distributing the shares to the public. On May 21, 1929, the 250,000 shares of Class A stock of North and South American Corporation were offered to the public by Baker, Kellogg & Co., Inc., and A. G. Becker & Co., Inc.[556] As the result of the sale of its Class A stock to the public, North and South American Corporation raised a total of $8,125,000 and the bankers derived a gross commission of $875,000.[557]

Meanwhile, on May 14, 1929, A. G. Becker & Co., Inc., Baker, Kellogg & Co., Inc., and American Founders Corporation had subscribed in equal proportions to 1,000,000 shares of the Class B stock of North and South American Corporation at $1 a share or a total cost of $1,000,000.[558] On July 8, 1929, the three sponsors entered into an agreement to retain at least 265,000 shares each of their holdings of the Class B stock of North and South American Corporation, and, if any of them desired to sell such shares, to grant to the other contracting parties a right to purchase such shares for a 30-day period at the price which any prospective outside purchaser had agreed

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[554] The principal group of investment companies in the so-called United Founders Corporation group included United Founders Corporation, American Founders Corporation, Investment Trust Associates, International Securities Corporation of America, Second International Securities Corporation, American & General Securities Corporation, United States & British International Co., Ltd., American and Continental Corporation, Founders General Corporation and Founders Associates. (See Part One of this report, House Doc. No. 707, 75th Cong., p. 100.)

[555] *Poor's Fiscal Volume,* 1934, p. 2814. The Class A stock was entitled to a prior noncumulative claim on the earnings of the company of $2 a share per annum and to further participation in any additional cash dividends in the ratio of $1 a share on the Class A stock for each 25 cents a share paid in on the Class B stock (ibid.). Put in another way, the Class B stockholders as a group were entitled to half the profits after payment of a fixed dividend of $2 a share on the Class A shares. For example, if the company earned a million dollars in any one year, $500,000 would be payable to the Class A stockholders. Thereafter 25 cents a share on each of the million shares of Class B stock would be paid. The Class B stock would thus receive $250,000. Finally, $1 a share, or a total of $250,000, would be paid on the 250,000 shares of Class A stock.

[556] Op. cit. supra, note 553, Commission's Exhibit No. X3795; and *Poor's Fiscal Volume,* 1934, p. 2814.

[557] The actual net profit made by the company's organizers on the sale of the 250,000 shares of its Class A stock to the public is not indicated by the record.

[558] Op. cit. supra, note 553, Commission's Exhibit No. X3795. The shares were taken as follows: Baker, Kellogg & Co., Inc., 333,334 shares; A. G. Becker & Co., Inc., 333,333 shares; and American Founders Corporation, 333,333 shares (ibid.).

to pay for the shares.[559] The board of directors of the company consisted entirely of representatives of the three sponsors.[560]

At the conclusion of the financing of North and South American Corporation, its sponsors had acquired, on an investment of $1,000,000, over 80% of the voting stock of the company which carried with it the control and the "leverage" of the $8,125,000 of the funds contributed to the enterprise by the public. Without accountability to the Class A stockholders for losses, the sponsors were in a position to speculate with the funds which the Class A stockholders had contributed to the company in an effort to create earnings for and to enhance the asset value of the Class B shares, which, as a group, were entitled by the provisions of the company's charter to one-half of the company's earnings after payment of a fixed noncumulative dividend of $2 per annum on the Class A shares,[561] and to all of the assets of the company after payment of $29 a share to the Class A stockholders.

In fact, as an incident of the financing of the company, the sponsors had, at its very inception, enhanced the asset value of their Class B shares by $875,000 at the expense of the Class A stockholders. As has been stated, 250,000 shares of the Class A stock had been sold to the public for $36 a share, or at a total price of $9,000,000. Of this sum, however, $875,000 was retained by the sponsors and the dealers who distributed the shares to the public as selling commissions. The remaining $8,125,000 was paid over to North and South American Corporation. However, the total liquidating preference of each share of the Class A stock was $29, or a total for the 250,000 shares outstanding of $7,250,000. The difference between the sum of $8,125,000, which the corporation received for its Class A shares, and their liquidating preference of $7,250,000 was thus applicable to the company's Class B shares which were held by the sponsors. In sum, if the investment company had been dissolved immediately after the conclusion of its financing, the Class A stockholders who had supplied the corporation with $8,125,000 would have received as a liquidating dividend $7,250,000, and the Class B stockholders who had contributed $1,000,000 to the company would have received $1,875,000 as a liquidating dividend.

North and South American Corporation raised a total of $9,125,000 as the result of the sale of its Class A and Class B stock. However, between 1929 and March 1932, when control of the company, as will be described hereafter, was acquired by Insurance Equities Corporation, North and South American Corporation repurchased 66,750 shares of its Class A stock at a cost of $577,050.[562] If the cost of these repurchased shares be treated as a return of a portion

[559] Op. cit. supra, note 553, Commission's Exhibit No. X3795. A. G. Becker & Co., Inc. had transferred its holdings of the Class B stock of North and South American Corporation to Domestic & Foreign Investors Corporation, a company under the control of that banking firm. Domestic & Foreign Investors Corporation entered into the agreement of July 8, 1929, with the other sponsors of North and South American Corporation.

[560] The directors of North and South American Corporation at the time of the sales of its control of Insurance Equities Corporation were F. H. Baker and J. C. Luitweiler of Baker, Kellogg & Co., Inc., J. M. Lee, S. J. Dicketts, G. E. Devendorf, and Erwin Rankin of the Founders group, and V. A. Johnston, Lester Roth, David Friday, and A. B. Schaffner of A. G. Becker & Co., Inc.

[561] See note 555, supra.

[562] Op. cit. supra, note 553, Commission's Exhibit No. X3796, Schedules 8, 10.

of the investment in the company made by its Class A stockholders, the net capital derived by the corporation on the sale of its outstanding shares was $8,547,950.

Almost immediately after the formation of the company [563] Baker, Kellogg & Co., Inc., one of its sponsors, sold to the company for $1,835,372 controlling blocks of the stock of Colombian Investment Company and its affiliated companies,[564] all of which were engaged in loaning funds on real estate and in investing in the securities of railroads, utilities, and banks situated in the Republic of Colombia, South America.[565] These companies will hereinafter be referred to as the "Colombian properties" of North and South American Corporation. No market existed for the securities of these Colombian companies acquired by North and South American Corporation from Baker, Kellogg & Co., Inc. By the spring of 1932, when control of North and South American Corporation passed to Insurance Equities Corporation, North and South American Corporation had invested in the securities of and had loaned to its Colombian properties a total of $3,822,031. However, the management of North and South American Corporation placed a value of approximately $572,000 on the Colombian properties.[566]

Of the remaining funds of North and South American Corporation $4,726,000 were invested by its sponsors in marketable securities, and these funds were augmented by substantial bank loans. On May 31, 1930, 1 year after the corporation had commenced operations, its bank loans totaled $775,000. On May 31, 1931, there were still outstanding bank loans in the sum of $375,000,[567] and at March 31, 1932, the bank loans incurred by the company totaled about $208,000.[568] In other words, in addition to the leverage afforded to the sponsors' Class B stock by the funds contributed to the company by the Class A stockholders, the sponsors also derived the additional leverage of bank borrowings.

However, the investments made by the sponsors in domestic securities resulted in substantial losses to the investment company. As at March 21, 1932, the company's assets other than its Colombian properties had a gross market value of approximately $610,000 and a net market value of approximately $400,000 after deducting the $208,000 owed to banks by the company.[569]

By March 1932, the net worth of North and South American Corporation was approximately $972,000 on the basis of the market value of its domestic securities (after deducting bank loans) and its management's appraisal of $572,000 as the value of the Colombian properties. In other words, by March 1932, the net capital fund of $8,547,950 which the investment company had derived from the sale

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[563] Id., at 26573.

[564] These companies were Cia Constructora Colombiana and Industrios San Fernando (id., Commission's Exhibit No. X3799 [p. 6]).

[565] Id., at 26574 and Commision's Exhibit No. X3792.

[566] Id., Commission's Exhibit No. X3796. A reserve of $3,250,000 had, by March 1932, been set up against the investment of $3,822,031 in the Colombian properties (ibid.).

[567] Id., Commission's Exhibits Nos. X3799 and X3780. These loans were collateralized by portfolio securities which had cost the company approximately $2,200,000 (ibid.).

[568] Stenographer's minutes, *Benedict* v. *Seagrave*, Supreme Court of the State of New York, New York County, Special Term, Part III, County Clerk's Index No. 45607 (1933), at 586.

[569] Id., at 585-6.

of its securities had depreciated in value by more than $7,500,000. As Louis H. Seagrave, the president of United Founders Corporation, testified, North and South American Corporation "did not fare very well during the depression years and eventually it shrank to a rather small company." [570]

Since the net assets of $972,000 of North and South American Corporation, as at March 1932, were substantially less than the liquidating preference of $5,314,250 against the corporation's assets possessed by the outstanding 183,250 shares of the company's Class A stock, the sponsors' holdings of the Class B stock, by March 1932, had no asset value. The Class A stock would have been entitled to all of the corporation's assets if it had then been dissolved and the Class A stockholders would have received approximately $5.30 a share. Thus, the Class A stockholder who in 1929 had purchased his stock at a cost of $36 a share and had retained his holdings through March 1932, had, under the management of United Founders Corporation group of investment companies, A. G. Becker & Co., Inc., and Baker, Kellogg & Co., Inc., suffered a loss of approximately $31 a share on his investment.[571]

Meanwhile, the United Founders Corporation group of investment companies had increased its holdings of the Class B stock of North and South American Corporation to the point of majority voting control by the purchase in December 1930, of the holdings of Baker, Kellogg & Co., Inc.[572] By March 1932, the United Founders Corporation group had accumulated 637,011 shares, or 64% of the Class B stock, and 42,713 shares or 22% of the Class A stock, of North and South American Corporation.[573]

Early in January 1932, Frederic P. Robert, an employee of the New York brokerage firm of E. A. Pierce & Company, who was acting in the capacity of a broker for the purchase and sale of investment companies,[574] approached George E. Devendorf, a vice president and director of American Founders Corporation,[575] to ascertain whether or not that company was willing to dispose of control of

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[570] Op. cit. supra, note 553, at 26570.

[571] Based on the market value of $1.25 a share of the Class A stock in March 1932, the Class A stockholder who had paid $36 a share for his stock in 1929 had suffered a loss of almost $35 a share on his investment.

[572] Baker, Kellogg & Co., Inc., sold to American Founders Corporation 314.916 shares of the Class B stock of North and South American Corporation for $267,639.50 (op. cit. supra, note 553, Commission's Exhibit No. 3797).

[573] Id., Commission's Exhibits Nos. X3801 and X3797. The total cost to the United Founders Corporation group of investment companies of the securities of North and South American Corporation was approximately $1,558,000 (id., Commission's Exhibit No. X3797). However, in March 1932, the securities of North and South American Corporation held by the United Founders Corporation group, had an asset value of approximately $213,565 and a market value of approximately $63,000, so that the United Founders Corporation group at this point had sustained an unrealized loss of substantially their entire investment in North and South American Corporation.

[574] Mr. Robert informed Mr. Devendorf that he "was head of a section of the business of E. A. Pierce, who were going to deal in buying and selling large blocks and control, if possible, of investment companies and he came over to see me to see whether or not there were any companies willing to sell or whether or not we were buying blocks or control of other companies; he was trying merely to establish a relationship so that he could intervene as a broker in the purchase or sale of large blocks of stock of investment companies which we might be interested in one side or the other" (op. cit. supra, note 568, at 684).

[575] Id., at 570.

some of its investment company subsidiaries. Mr. Devendorf informed Mr. Robert that the United Founders Corporation group would be willing to dispose of control of North and South American Corporation.

Mr. Robert, in his negotiations with Mr. Devendorf, was then representing Frank Cohen, a vice president, general manager, and a director of Lloyds Casualty Company of New York, and a vice president of Detroit Fidelity and Surety Company.[576] Both of these casualty insurance companies by 1932 had suffered large losses.[577]

Mr. Cohen had evolved a plan to consolidate these companies with the Constitution Indemnity Company of Philadelphia, and other companies,[578] to form a new company to be known as Lloyds Insurance Company of America.[579] In addition to this plan for the consolidation of casualty insurance companies, Mr. Cohen also contemplated the acquisition of control of and the eventual merger of several of the lesser known capital stock type life insurance companies.[580]

To facilitate this plan, however, it would be necessary to acquire controlling or large blocks of the stocks of the various insurance companies involved. But Mr. Cohen did not have substantial personal funds. Accordingly, as another aspect of his plan, he intended to acquire control of several investment companies and to use their assets to acquire control of insurance companies.[581] Mr. Cohen also intended to use the assets of the investment companies themselves to pay for his control. This last facet of his plan involved the creation of a holding company which would sell its securities to the investment

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[576] Id., at 700; *Moody's Manual of Investments, Banks, etc.*, 1932, p. 2386.

[577] In 1929 Lloyds Casualty Company of New York had a total capital and surplus of $4,644,000 (op. cit. supra, note 568, at 1202). However, in 1929 it had suffered losses on both insurance underwritings and investments, of $812,353. In 1930 its losses on underwriting and investments were $1,343,493. In 1931 such losses totaled $1,504,688, and in 1932 its losses totaled $2,762,034 (id., at 1202–4). By the end of 1932 the total losses of the company had exceeded the company's capital and paid in surplus (id., at 1207). The ratio of losses suffered in underwritings to total earned premiums of Lloyds Casualty Company in 1932 was 78.7%. Similarly, the underwriting losses and losses on investments of the Detroit Fidelity and Surety Company for 1929 were $550,000. In 1930 such losses were $200,323, and in 1931 such losses totaled $458,567 (id., at 1208). The ratio of losses on underwritings to total earned premiums of Detroit Fidelity and Surety Company for 1929 was 82.8% and for 1930, 79.3% (id., at 1209). Mr. Cohen, however, testified (id., at 1207–8):

> Q. And, of course, you know, don't you, that some of these companies in making up their statements adopted as far as possible where it could be done, not to show so much loss, and through adjustment of values and other methods to hold down these tremendous losses?
> A. I would say yes.

[578] One such company was the Penn General Casualty Company. See the discussion of the acquisition by Insurance Equities Corporation of Insuranshares Corporation of Delaware, infra, pp. 1193–1225.

[579] Op. cit. supra, note 568, at 1124.

[580] The companies which Mr. Cohen had under consideration included Jefferson Standard Life Insurance Company of North Carolina, Occidental Life Insurance Company of North Carolina, Shenandoah Life Insurance Company of Virginia, Philadelphia Life Insurance Company, and Kentucky Home Life Insurance Company, all of which he planned to merge with Jefferson Standard Life Insurance Company (id., at 1124–5 and 1150). Subsequently, the assets of Insuranshares Corporation of Delaware, control of which was acquired by Mr. Cohen's company, Insurance Equities Corporation, in May 1932, were used to further Mr. Cohen's plan. See infra, pp. 1193–1225.

[581] Op. cit. supra, note 568, at 1609. Mr. Cohen testified: "The only interest I had in these investment trusts was to be able to carry through a program on these insurance companies" (id., at 1254).

companies acquired and would use the proceeds of such sales to pay for the controlling block of stocks of the investment companies.[582]

In this venture Mr. Cohen had the assistance of S. Stanwood Menken, of the New York law firm of Menken, Ferguson and Hill, and Carl Sherman, a former Attorney General of the State of New York, and then a member of the law firm of Sherman and Goldring. The law firms of both Mr. Menken and Mr. Sherman became counsel for Insurance Equities Corporation, the holding company formed by Mr. Cohen as part of his plan. The firm of Menken, Ferguson and Hill was paid $65,000 as counsel fees by Insurance Equities Corporation for two-thirds of the year 1932, and Messrs. Sherman and Goldring were employed by Insurance Equities Corporation at an annual retainer of $25,000.[583] As will be seen later, the sums paid to these attorneys by Insurance Equities Corporation were derived by Insurance Equities Corporation from the assets of North and South American Corporation and of Insuranshares Corporation of Delaware, control of which had been acquired from the United Founders Corporation group.

On April 11, 1932, Julius H. Barnes, then the chairman of the Chamber of Commerce of the United States,[584] at the suggestion of Mr. Menken, agreed to become associated with the various companies controlled or to come under the control of Mr. Cohen, at an annual salary of $50,000 a year for five years. Mr. Barnes actually received $29,456 in salaries from the various investment and insurance companies[585] which came under Mr. Cohen's control and in addition borrowed $57,125 from Insurance Equities Corporation.[586] Mr. Barnes took no part in the acquisition by Insurance Equities Corporation of control of North and South American Corporation. He first got into "active service"[587] with the group on May 3, 1932, when Insurance Equities Corporation acquired control of Insuranshares Corporation of Delaware. Mr. Barnes testified as to the reasons advanced by Mr. Menken for desiring his connection with the Cohen group, that:[588]

"He [Menken] found that many of the controlling owners of these [investment] trusts were also the original sponsors and concerned as to their management after they parted with control and stated that it would facilitate the program if I would associate myself with that group, and in the event of purchases of these investment companies, take over the head executive position."

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[582] Id., at 1224–5, 1250, and 1258–60. Mr. Cohen testified (id., at 1224–5):

A. Insurance Equities Corporation expected to sell its preferred stock and pay for it [control of investment companies.]

Q. And it expected to sell its preferred stock to North and South American Corporation?

A. And to others.

[583] Id., at 1135. Other members of the Cohen group included Julius H. Barnes (see infra), Franklin Berwin, Percy Biglin, and Dale Parker (of Brown Brothers, Harriman & Company), who gave financial advice to the group (id., at 1620, 1673–4).

[584] Id., at 1610.

[585] Mr. Barnes received as a salary, $10,595.70 from Insuranshares Corporation of Delaware and Insuranshares & General Management Company, from May 3, 1932, to August 1933, and in addition received $4,986 from Lloyds Insurance Company of America, and $13,875 from Insurance Equities Corporation (id., at 1618).

[586] Id., at 1619. This loan had been unpaid on the date of Mr. Barnes' testimony (ibid.).

[587] Id., at 1613–4.

[588] Id., at 1610.

Early in March 1932, prior to the time that Mr. Barnes became associated with the group, Mr. Cohen instructed his attorney, S. Stanwood Menken, to form the holding company required for the fulfillment of his plans.[589] On March 9, 1932, Mr. Menken caused Insurance Equities Corporation to be formed in Delaware with an authorized capitalization of 50,000 shares of $100 par value preferred stock and 600,000 shares of no par value common stock.[590] Prior to the purchase by Insurance Equities Corporation of North and South American Corporation, Insurance Equities Corporation had a dummy board of directors,[591] no assets, and has issued no stock.[592] In fact, no stock certificates had even been printed.[593]

Meanwhile, from February 1929 Mr. Robert and Mr. Menken had been negotiating with George E. Devendorf, as the vice president of American Founders Corporation, for the purchase from the United Founders Corporation group of investment companies of control of North and South American Corporation. In the course of these negotiations, Mr. Menken stated to Mr. Devendorf the plan of his client, Mr. Cohen, to acquire control of and to merge insurance companies, and also stated that the group which he represented had over $5,000,000 of resources.[594] Mr. Devendorf made some investigation of the background of Mr. Cohen and Mr. Menken and had ascertained that Mr. Cohen was a vice president of Lloyds Casualty Company of New York and that Mr. Menken was a "prominent attorney." [595]

However, although Mr. Devendorf ascertained that the actual purchaser of the control of North and South American Corporation was to be Insurance Equities Corporation, he made no attempt to investigate the financial responsibility of that corporation.[596] As has been stated, Insurance Equities Corporation was then a mere shell having no assets.

In the course of the negotiations the United Founders Corporation group permitted representatives of Mr. Cohen to make an audit of the books and records of North and South American Corporation.[597] The interest of the Cohen group centered in the liquid domestic securities held by the North and South American Corporation. They did not desire the Colombian properties. As a consequence, the parties agreed that the Colombian properties of North and South American Corporation would be transferred to a new company which would issue its preferred stock pro rata to the Class A stockholders

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589 Id., at 1219.

590 Ibid., and *Moody's Manual of Investments, Banks, etc.*, 1934, p. 2698.

591 Maurice D. Adams, a director and the president of Insurance Equities Corporation, testified that none of the directors of that company had anything to do with transactions between Insurance Equities Corporation and others, and that they merely read and signed minutes of directors' meetings prepared by S. Stanwood Menken (op. cit. supra, note 568, at 498).

592 Id., at 501, 513–5.

593 Id., at 495–7.

594 Id., at 699, 724. Mr. Menken also informed Mr. Devendorf that he was satisfied with his clients and "enthusiastic" about them and their plans (id., at 700).

595 Id., at 700. Mr. Devendorf testified that he received "Bishop's" Reports on Mr. Cohen and Mr. Menken (id., at 703).

596 Id., at 619. Mr. Devendorf testified that he felt no report on Insurance Equities Corporation was necessary because control of North and South American Corporation was to be sold not on any installment plan but as a single "cash transaction" (ibid.).

597 Id., at 694.

of North and South American Corporation, including the United Founders Corporation group of companies.[598]

The negotiations then continued for the purchase of control of North and South American Corporation as reconstituted after the elimination of the "Colombian properties." The reconstituted company held only cash and marketable securities having a total value, as has been stated, of $609,000 and a net value of approximately $401,000 after deduction of an outstanding bank loan of $208,000.

On March 19, 1932, Insurance Equities Corporation agreed [599] to purchase from the United Founders Corporation group of investment companies, 42,713 shares of the Class A stock of North and South American Corporation for $128,139 and 537,011 shares of the Class B stock of the same company for $125,000. The total consideration to be paid to the United Founders Corporation group for their holdings of the stock of North and South American Corporation was, therefore, $253,139—a sum in excess of half of the net worth of North and South American Corporation after the elimination of the Colombian properties from its portfolio. Moreover, the Class B stock had no asset value, and the Class A stock had an asset value of $2.18 a share [600] or a total asset value for the 42,713 shares of approximately $93,000.[601] Insurance Equities Corporation, therefore, had contracted to pay $160,000 in excess of the actual asset value of the stock it was purchasing. The United Founders Corporation group of companies also agreed to deliver all of the offices and six of the ten directorships of North and South American Corporation to Insurance Equities Corporation and "to cause North and South American Corporation to produce at the closing such securities as it has in its so-called American portfolio excluding such as are pledged as collateral for bank loans." Mr. Devendorf testified that he assumed that Insurance Equities Corporation desired this

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[598] Id., at 577–8; and op. cit. supra, note 553, Commission's Exhibit No. X3801. In August 1932 the new company, Colombian Holding Corporation (*Moody's Manual of Investments, Banks, etc.*, 1933, p. 2511) was formed and issued its preference stock share for share to the Class A stockholders of North and South American Corporation. The United Founders Corporation group of companies obtained 42,713 shares of the preferred stock of Colombian Holding Corporation which were sold in October 1933 for proceeds of approximately $15,000 (op. cit. supra, note 553, Commission's Exhibit No. X3803). The common stock of the Colombian Holding Corporation apparently was issued to North and South American Corporation. However, the preferred stockholders of the new company were to be paid a total of $7 a share or an aggregate of $1,382,750 out of the assets of the company before any sum would accrue to the common stock. Since the sum to be paid to the preferred stockholders of Colombian Holding Corporation exceeded the then estimated value of approximately $572,000 for the "Colombian properties," the common stock of the new company was of doubtful value. Furthermore, it was provided that no indebtedness was to be created by the new company except with the consent of the holders of 80% of its outstanding preferred stock, and the preferred stock was to have a sinking fund into which all sums realized from the sale of the assets of the new company were to be paid until $7 a share had been paid on the preferred stock (id., Commission's Exhibit No. X3801). In other words, the preferred stockholders of the new company were substantially protected against any attempt by Insurance Equities Corporation to invest its funds for its own purposes.

[599] Op. cit. supra, note 553, Commission's Exhibit No. X3801.

[600] The net assets of North and South American Corporation, after elimination of the Colombian properties, was approximately $400,000, and there were outstanding 183,250 shares of Class A stock entitled on dissolution of the company to receive $29 a share.

[601] The market value of the two blocks of stock did not exceed $63,000. The Class B stock had no market, and the Class A stock had a quoted market value, in March 1932, of $1.25 a share.

provision in the contract in order to enable its representatives to check over the portfolio of North and South American Corporation.[602] However, the United Founders Corporation group had previously permitted the representatives of Insurance Equities Corporation to make an audit of North and South American Corporation. Presumably, therefore, the representatives of the Cohen group had verified the existence of the portfolio of North and South American Corporation. The actual purpose of Insurance Equities Corporation in requiring this provision in the contract will be described later.

During the course of the negotiations between Mr. Devendorf and Mr. Menken, Mr. Devendorf had informed Mr. Menken that, under the provisions of the agreement of July 8, 1929, between American Founders Corporation, Baker, Kellogg & Co., Inc., and Domestic & Foreign Investors Corporation, which was "more or less" A. G. Becker & Co., Inc., the United Founders Corporation group would be required to offer their Class B stock in North and South American Corporation to Domestic & Foreign Investors Corporation for a period of 30 days.[603]

Immediately after being informed of this fact, Mr. Menken and Mr. Cohen entered into negotiations to purchase the 321,766 shares of Class B stock of North and South American Corporation held by Domestic & Foreign Investors Corporation, for $71,850.[604] Mr. Devendorf was informed of this fact by Mr. Cohen and Mr. Menken,[605] so that prior to the closing of the contract of the United Founders Corporation group to deliver control of North and South American Corporation to Insurance Equities Corporation, Mr. Devendorf was aware of the fact that Insurance Equities Corporation had agreed to pay $324,989 to acquire only a 22% ownership interest in an investment company possessing net assets of $400,000. Louis H. Seagrave, the president of American Founders Corporation, when questioned on this point, testified: [606]

Q. The total price that was being paid for these securities by Insurance Equities was $324,000 to have control of and a 22% interest in the preferred stock of the company, that did not impress you as being at all out of proportion to the assets which were being acquired?

A. I thought it was a fair contract.

On March 21, 1932, the closing of the contract between the United Founders Corporation group of investment companies and Insurance Equities Corporation took place.[607] Before the actual closing, however, Mr. Menken informed Murray Taylor, counsel for the United Founders Corporation group of companies, that, because Insurance Equities Corporation had unexpectedly been required to purchase the Class B stock of North and South American Corporation held by Domestic & Foreign Investors Corporation, Insurance Equities Corporation lacked $20,000 of the funds necessary to pay its total obligations at the closing. Mr. Menken suggested that American Founders Corporation loan Insurance Equities Corporation $20,000 in order not

[602] Op. cit. supra, note 568, at 705.
[603] Id., at 696–7.
[604] Id., at 697.
[605] Ibid.
[606] Id., at 1437.
[607] Id., at 704.

to delay the closing.[608] American Founders Corporation thereupon loaned Insurance Equities Corporation $20,000,[609] which was paid over by Insurance Equities Corporation at the closing to Domestic & Foreign Investors Corporation in part payment for that corporation's holdings of the Class B stock of North and South American Corporation. Notwithstanding the fact that Mr. Devendorf had been informed by Mr. Menken that his clients had possessed resources of over $5,000,000, Mr. Devendorf found nothing suspicious in the request of Insurance Equities Corporation for a loan of $20,000.[610]

On the morning of March 21, 1932, the date of the closing of the contract for the sale of control of North and South American Corporation, all of the representatives of the United Founders Corporation group and of A. G. Becker & Co., Inc., resigned as officers and directors of North and South American Corporation and were replaced by representatives of the Cohen group.[611] At this point, however, the United Founders Corporation group of investment companies had received no payment for their stock in North and South American Corporation.[612]

After control of North and South American Corporation was thus turned over to the Cohen group before they had made any payment for such control, the representatives of the United Founders Corporation group of investment companies and of A. G. Becker & Co., Inc., retired from the meeting. The new directors thereupon passed a resolution authorizing North and South American Corporation to borrow $508,000 from the Bank of Manhattan Trust Company and to deliver the entire portfolio [613] of North and South American Corporation to the representative of the bank who was present at the meeting. The bank's representative delivered its check for $508,000 and received the portfolio securities. The bank was authorized to sell the securities, deduct the amount of its loan from the proceeds of their sale, and to remit the balance of such proceeds to North and South American Corporation.[614] The bank subsequently disposed of the portfolio of North and South American Corporation for proceeds of approximately $609,000, deducted its $508,000 loan, and remitted $101,000 to North and South American Corporation.

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[608] Id., at 1544.

[609] The check for the $20,000 loan was signed by Mr. Devendorf (id., Commission's Exhibit No. 81).

[610] Id., at 795.

[611] The new directors included Franklin Berwin, E. D. Belknap, Esmond P. O'Brien, Lewis H. Pounds, and Victor Sincere (*Moody's Manual of Investments, Banks, etc.*, 1933, p. 2511).

[612] Op. cit. supra, note 568, at 1569. Mr. Devendorf, who was the president and a director of North and South American Corporation, testified (id., at 609):

> Q. When you came to the meeting on March 21, 1932, you didn't ask to see the certified check of Insurance Equities before you resigned, did you?
> A. I did not. I had nothing to do with receiving the payment.

[613] The portfolio of North and South American Corporation was physically present at the closing in accordance with the terms of the contract for the purchase of control of North and South American Corporation by Insurance Equities Corporation.

[614] Mr. Cohen testified that Mr. Menken had made this arrangement with the Bank of Manhattan Trust Company prior to the closing of the contract for the purchase by Insurance Equities Corporation of control of North and South American Corporation (op. cit. supra, note 568, at 1229). Mr. Cohen further testified that all loans made by Insurance Equities Corporation from banks were arranged through Mr. Menken because he "knew most of the banking people which I didn't" and "he would talk to them in advance and make arrangements in advance, and I would come in toward the end" (id., at 1360–1).

In sum, virtually the entire portfolio of North and South American Corporation was almost immediately liquidated by Insurance Equities Corporation for proceeds of $609,000. Of this sum, $208,000 was used to repay an existing indebtedness of North and South American Corporation to the Central Hanover Bank & Trust Company.[615] The bulk of the remaining $401,000 of assets of North and South American Corporation was in effect transferred to Insurance Equities Corporation in order to enable it to derive the funds to pay the United Founders Corporation group of investment companies and Domestic & Foreign Investors Corporation for control of North and South American Corporation.

On March 21, 1932, directly after the receipt of the $508,000 from the Bank of Manhattan Trust Company, the Cohen group-controlled board of directors of North and South American Corporation passed a resolution to have North and South American Corporation expend $350,350 in the purchase of 3,500 shares of the common stock and 3,500 shares of the preferred stock of Insurance Equities Corporation.[616] Insurance Equities Corporation, in this manner, for the first time came into possession of some assets. Late in the afternoon of March 21, 1932, the date of the closing of the purchase agreement, Insurance Equities Corporation delivered its certified checks for $253,139 and $51,850, respectively, to the United Founders Corporation group of investment companies and to Domestic & Foreign Investors Corporation in payment for the controlling block of stock of North and South American Corporation.[617] These funds, as has been stated, had been derived from the assets of North and South American Corporation, so that in effect the funds of the company itself had been used by Insurance Equities Corporation to pay for its control. Louis H. Seagrave, the president of American Founders Corporation, although he denied that he had prior knowledge of the method by which Insurance Equities Corporation intended to acquire the funds to pay for the control of Insurance Equities Corporation, conceded that Insurance Equities Corporation had used the assets of North and South American Corporation for this purpose.[618] It will be recalled, however, that the United Founders Corporation group of investment companies had made no investigation of the financial worth of Insurance Equities Corporation.

As a result of the passage of control of North and South American Corporation, $350,350 of its approximate net assets of $400,000 which previously had consisted of marketable securities, had been transformed into an investment in the stock of Insurance Equities Corporation. The stock of Insurance Equities Corporation held by North and South American Corporation had an asset value of approximately $11,000.[619] Against these assets, however, Insurance Equities

[615] Id., at 542.

[616] Id., Commission's Exhibits 89A, 89B, 90, 90B, 90C, 90D.

[617] Id., at 520–2 and 613–4. It will be recalled that Insurance Equities Corporation had paid $20,000 of its total obligation of $71,850 to Domestic & Foreign Investors Corporation by means of a loan obtained from American Founders Corporation.

[618] Op. cit. supra, note 553, at 26581.

[619] Aside from its holdings of the stock of Insurance Equities Corporation, the assets of North and South American Corporation had a value of $50,000 and in these assets Insurance Equities Corporation had an approximately 22% interest by virtue of its holdings of 42,713 shares of the Class A stock of North and South American Corporation which it had acquired

Corporation owed American Founders Corporation $20,000. Moreover, the $45,361 balance [620] of the $350,350 which had been received by Insurance Equities Corporation from North and South American Corporation in payment for the preferred and common stock of Insurance Equities Corporation, was promptly disbursed to members of the Cohen group and others. On March 24, 1932, Insurance Equities Corporation paid $8,425 to the law firm of Sherman and Goldring.[621] Frederic P. Robert, the broker in the transfer of control of North and South American Corporation from the United Founders Corporation group of investment companies to Insurance Equities Corporation, received $10,000 from Insurance Equities Corporation as a commission.[622]

Finally, Insurance Equities Corporation paid $25,000 and issued 35,000 shares of its common stock to Frank Cohen in return for 4,000 shares, or 10%, of the stock of Detroit Fidelity and Surety Company and 10,000 shares, or 5%, of the stock of Lloyds Casualty Company of New York.[623] Thus, Mr. Cohen, by the use of the funds of North and South American Corporation, had acquired large blocks of the stock of two insurance companies which were included in this general plan to acquire control of and to merge casualty and life insurance companies. In addition, Mr. Cohen had acquired control of Insurance Equities Corporation.[624]

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from the United Founders Corporation group of investment companies. The Class B stock of North and South American Corporation held by Insurance Equities Corporation, it will be recalled, had no asset value.

[620] Insurance Equities Corporation had obtained $350,350 by the sale of its stock to North and South American Corporation and had immediately disbursed $304,989 to pay for control of North and South American Corporation.

[621] Op. cit. supra, note 568, at 520–2.

[622] Id., at 522–5 and Commission's Exhibits Nos. 79, 80B, 80C, and 80D. The United Founders Corporation group of investment companies also paid Mr. Robert $10,000 for his services in connection with the sale of control of North and South American Corporation to Insurance Equities Corporation (op. cit. supra, note 553, Commission's Exhibit No. X3802).

[623] Op. cit. supra, note 568, at 520–6, 1259, and 1275–8. Lloyds Casualty Company of New York then had outstanding 200,000 shares of $5 par value capital stock, and Detroit Fidelity and Surety Company had outstanding 40,000 shares of capital stock (id., at 1118). Mr. Cohen had entered into an agreement with Insurance Equities Corporation which bound that corporation to purchase from him an aggregate of 32,000 shares of the stock of Detroit Fidelity and Surety Company and 100,000 shares of Lloyds Casualty Company. In all, Mr. Cohen, by May 19, 1932, delivered 22,315 shares of the stock of Lloyds Casualty Company and 4,000 shares of Detroit Fidelity and Surety Company to Insurance Equities Corporation (id., at 997) for which he received, from March 22, 1932, to April 13, 1933, a total of $233,210 in cash and 307,648 shares of its common stock from Insurance Equities Corporation (id., at 990–4). The market value of the stock of Lloyds Casualty Company was approximately $2 a share and that of Detroit Fidelity and Casualty Company approximately $7 a share, so that the total market value of the stocks of these companies delivered by Mr. Cohen to Insurance Equities Corporation was approximately $73,000. The $233,210 which Mr. Cohen received from Insurance Equities Corporation was derived by that corporation almost entirely from its various transactions with North and South American Corporation and Insuranshares Corporation of Delaware, control of which was acquired by Insurance Equities Corporation from the United Founders Corporation group of investment companies on May 3, 1932 (id., at 993). Max Frendel, a certified public accountant who had examined the books and records of Insurance Equities Corporation, testified that of the $233,210 paid by that corporation to Mr. Cohen, $30,000 went into Mr. Cohen's personal bank account and the remainder was used to pay "debts, I presume of Cohen and others" (id., at 995).

[624] Mr. Cohen testified (id., at 1250):

> Q. In essence, Mr. Cohen, that was the arrangement, wasn't it, that all of the money to make the payment to the broker, to the attorneys, for the payment of the shares of Lloyds and Detroit, that you were getting—the payment to American Founders and the payment to Domestic & Foreign Securities—was to come out of the subscription by

As has been stated, $350,350 of the total assets of $401,000 of North and South American Corporation had been invested in the preferred and common stock of Insurance Equities Corporation. All of the remaining funds of North and South American Corporation were invested, in May 1932, in the purchase from United States Shares Corporation of contracts to distribute and manage the assets of nine semifixed trusts.[625] By May 31, 1933, these management and distribution contracts had been written down to one dollar on the books of North and South American Corporation,[626] and on February 14, 1934, Insurance Equities Corporation, which throughout its active existence had been insolvent,[627] was placed in receivership.[628] As a result, the $350,350 investment of North and South American Corporation in the stock of Insurance Equities Corporation became worthless.

As a result, therefore, of the passage of control of North and South American Corporation to Insurance Equities Corporation, the Class A stockholders of North and South American Corporation had suffered a complete loss of the remaining value of their investment in the company. However, the United Founders Corporation group of investment companies, which had sponsored, unsuccessfully managed, and controlled North and South American Corporation, had received an attractive price for their holdings of the stock of North and South American Corporation. In the course of their advantageous disposition of their holdings in and their control of North and South American Corporation, the United Founders Corporation group, however, had taken no substantial steps to protect the company's minority stockholders. No investigation of the financial worth of Insurance Equities Corporation had been attempted by the

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North and South American for the preferred and common stock of Insurance Equities?
A. I have tried to tell you it would come out of the sale of preferred stock and whatever we could borrow on the North and South American shares and on the Detroit and Lloyd Casualty stock * * *.

[625] *Moody's Manual of Investments, Banks, etc.*, 1935, p. 1598. The semifixed trusts whose sponsorship was acquired by North and South American Corporation were Common Stock Trust Shares, Series A-1; United Common Trust Shares, Series 2; United Insurance Trust Shares, Series F; United Oil Trust Shares, Series H; United Fixed Shares, Series Y; Common Stock Trust Shares, Series A; Bank Trust Shares, Series 1 and 2; and United New York Bank Trust Shares. While the record does not indicate the purpose of the Cohen group in acquiring the sponsorship of these semifixed trusts, it is significant that one of the plans later evolved by the Cohen group in order to derive funds for Insurance Equities Corporation was to exchange the stock of Insuranshares Corporation of Delaware, which Insurance Equities Corporation had acquired from the United Founders Corporation group of investment companies, for certificates of beneficial interest in fixed trusts. The fixed trust certificates were then to be tendered to the trustee for conversion into the marketable securities held by the trustee for the benefit of the certificate holders. Insurance Equities Corporation would then derive cash by selling the marketable securities so acquired (op. cit. supra, note 568, at 1405–12). The position of sponsorship held by North and South American Corporation in the 9 semifixed trusts would give the Cohen group access to the lists of the certificate holders of the trusts, a desirable advantage of an exchange offer program for the certificates of the trust. In July 1932, Insurance Equities Corporation actively retained Allied General Corporation, a company engaged in the distribution of investment company securities, to conduct a program of exchanging Insuranshares Corporation of Delaware stock for the certificates of beneficial interest of fixed trusts. However, Allied General Corporation terminated the arrangement shortly after it was made, and Insurance Equities Corporation apparently discontinued the program (id., at 1639–40).

[626] Op. cit. supra, note 553, Commission's Exhibit No. X3796.

[627] Op. cit. supra, note 568, at 993. See infra, *Insuranshares Corporation of Delaware—Insurance Equities Corporation*, pp. 1193–1225.

[628] *Moody's Manual of Investments, Banks, etc.*, 1935, p. 1597.

United Founders Corporation group. The United Founders Corporation group did not exact any commitment from Insurance Equities Corporation to continue the existing investment policy of North and South American Corporation. They accepted only Mr. Menken's oral assurance that the new management "expected to continue North and South American Corporation more or less the same way it had been run in the past." [629] Finally, in June 1932, when the United Founders Corporation group of investment companies became aware of the fact [630] that North and South American Corporation had invested all of its funds in the stock of Insurance Equities Corporation, the officers of the United Founders Corporation group took no steps to compel Insurance Equities Corporation to restore the original portfolio of North and South American Corporation.[631]

h. Insuranshares Corporation of Delaware—Insurance Equities Corporation

Almost immediately after the acquisition of North and South American Corporation by Insurance Equities Corporation, the Cohen group which, after April 11, 1932, had the prestige of the association with it of Julius H. Barnes, the chairman of the Chamber of Commerce of the United States,[632] began to negotiate for the purchase of control of Insuranshares Corporation of Delaware from the United Founders Corporation group of investment companies.

Insuranshares Corporation of Delaware had been incorporated in Delaware on July 31, 1928, with general power to invest in securities.

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[629] Op. cit, supra, note 568, at 601.

[630] Mr. Devendorf testified that in June 1932 he saw the May 31, 1932 report of North and South American Corporation, which showed its $350,350 investment in the preferred and common stocks of Insurance Equities Corporation (id., at 706–7 and 776–9).

[631] Id., at 1469. Louis H. Seagrave, the president of American Founders Corporation, testified that in his opinion protection of minority stockholders against the possible injurious consequences of a transfer of the control of their funds of their companies to others was desirable (op. cit. supra, note 553, at 26582–3):

> Q. Well, again, Mr. Seagrave, what do you think of the desirability of permitting one investment trust, or the officers of an investment trust to sell out to another trust, where it has been shown over and over again that these things may happen? Shouldn't there be some protection to the stockholders of the investment trust in that situation?
> A. You are speaking in general.
> Q. I am speaking in general. I am talking about your point of view today—I am not talking about what happened in the past—as you look upon it, sitting here with the proof of your experience.
> A. I certainly think that if there is a feasible way of protecting the companies and the stockholders thereof against that kind of operation, it certainly should be applied. On the other hand, it doesn't seem to me that the owners of an investment company should be prohibited by law from selling their property. In between there, I don't know what is possible.
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> * * * * * * *
>
> Q. In other words, there is no particular reason why large funds of public moneys shouldn't be protected at all times, is there?
> A. I am with you 100 per cent.

[632] See supra, p. 1185. Hobart B. Brown, the president and a director of Insuranshares Corporation of Delaware prior to the shift of its control to Insurance Equities Corporation and who continued as a director of the company after the passage of its control to the Cohen group, until December 22, 1932 (op. cit., supra, note 568, at 61 and 233) testified that his confidence in Mr. Barnes, who became chairman of the board of directors of Insuranshares Corporation of Delaware and whom "he knew by reputation," led him to approve various transactions between Insurance Equities Corporation and Insuranshares Corporation of Delaware which subsequently resulted in substantial losses to Insuranshares Corporation of Delaware (id., at 231). Mr. Barnes, however, testified that he approved the same transactions in reliance on the advice of S. Stanwood Menken and Carl Sherman, counsel for both Insuranshares Corporation of Delaware and Insurance Equities Corporation (id., at 1619–20).

The charter of the corporation, however, prohibited the investment of more than 5% of its assets in the securities of any one company with the exception that not more than 10% of its assets could be invested in the securities of any one bank or insurance company. However, no limitation was imposed upon the amount of the corporate funds which could be invested in the securities of a corporation "engaged in a type of business similar" to that of Insuranshares Corporation of Delaware.[633]

Insuranshares Corporation of Delaware was organized by Insuranshares Corporation of New York[634] and Insuranshares and General Management Company,[635] both of which were originally controlled by Sterling Pile, Edward B. Twombly, Schoellkopf, Hutton & Pomeroy, Inc., investment bankers, and Goodwin, Beach & Co., an investment firm specializing in insurance company securities and headed by Edward S. Goodwin, a reputed authority on such securities.[636]

The original authorized capital of Insuranshares Corporation of Delaware consisted of a Class A common stock and a Class B common stock. The Class A common stock was entitled on liquidation of the company to a preference in assets to the extent of $20 a share, and thereafter the remaining assets were to be divided in the ratio of 85% to the Class A common stockholders and 15% to the Class B stockholders. For all corporate purposes other than the election of directors, the two classes of stock had equal voting rights. However, for the election of directors, the Class A stock had one vote a share multiplied by the number of directors to be elected, whereas, the Class B stock had three votes a share multiplied by the number of directors to be elected.[637]

On March 1, 1929, Insuranshares Corporation of New York purchased 50,000 shares of Insuranshares Corporation of Delaware Class B stock at a price of 10 cents a share.[638] On the same day, Insuranshares and General Management Company agreed to recommend investments for the portfolio of Insuranshares Corporation of Delaware.[639] As sole and complete compensation for its management services, Insuranshares and General Management Company was permitted to purchase 450,000 shares of the Class B stock of Insuranshares Corporation of Delaware at a price of 10 cents a share.[640] In these transactions, Insuranshares Corporation of Delaware had issued 500,000 shares of its Class B stock for a total consideration of $50,000.

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633 *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2509.

634 This corporation changed its name to Allied General Corporation in 1931. See infra, pp. 1349–57.

635 The original name of this corporation was Insuranshares Management Company. The name used in the text was adopted in May 1930 (*Moody's Manual of Investments, Banks, etc.*, 1933, p. 2508).

636 Public Examination, Allied General Corporation, at 4948, 5010; and op. cit., supra, note 568, at 154.

637 Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1908.

638 Ibid.

639 Ibid. Edward S. Goodwin, a reputed authority on insurance company securities, was head of the research department of Insuranshares and General Management Company (op. cit. supra, note 568, at 80–1).

640 Public Examination, Allied General Corporation, at 5048.

On March 5, 1929, The Goldman Sachs Trading Corporation purchased 250,000 shares of the Class A stock of Insuranshares Corporation of Delaware for $5,000,000,[641] and on March 14, 1929, Insuranshares Corporation of New York publicly offered at $21⅞ a share, 500,000 shares of the Class A stock of Insuranshares Corporation of Delaware. From the proceeds of this public offering, Insuranshares Corporation of New York retained $937,500 as gross selling commissions and remitted $10,000,000 to Insuranshares Corporation of Delaware.

Thus, by the end of March 1929, Insuranshares Corporation of Delaware had raised total capital funds of $15,050,000, of which $15,000,000 represented the consideration for the issuance of 750,000 shares of its Class A stock and $50,000 represented the amount obtained from the sale of 500,000 shares of its Class B common stock. The Class B common stockholders who had contributed only $50,000 to the enterprise, nevertheless, were in permanent control of the management and policies of the corporation.[642]

The connection of The Goldman Sachs Trading Corporation with Insuranshares Corporation of Delaware lasted exactly one year. On March 5, 1930, The Goldman Sachs Trading Corporation and American Cities Power & Light Corporation, to which The Goldman Sachs Trading Corporation had previously sold 150,000 shares of the Class A stock of Insuranshares Corporation of Delaware, sold to the United Founders Corporation group of investment companies 250,000 shares of the Class A stock of Insuranshares Corporation of Delaware for $4,000,000. At the same time, Insuranshares and General Management Company sold 20,000 shares of its own stock to the United Founders Corporation group of investment companies for $500,000.[643] In sum, the United Founders Corporation group of investment companies, at an aggregate cost of $4,500,000, had acquired, in March 1930, 250,000 shares or one-third of the Class A stock of Insuranshares Corporation of Delaware and 20,000 shares

[641] Op. cit, supra, note 637, Commission's Exhibit No. 1908. The Goldman Sachs Trading Corporation also purchased from Insuranshares Corporation of New York 25,000 shares of the Class B stock of Insuranshares Corporation of Delaware at 12 cents a share, or a total price of $3,000, and 10,000 shares of the stock of Insuranshares and General Management Company at a price of $200,000. Waddill Catchings of Goldman, Sachs & Co. was elected a director of Insuranshares Corporation of Delaware (ibid).

[642] As has been indicated, the Class A stock had one vote a share multiplied by the number of directors to be elected, and the Class B shares had three votes a share multiplied by the number of directors to be elected. The inequity of this arrangement of the voting power of the corporation, when compared with the capital contribution made to the enterprise by the two classes of stocks, led the New York Curb Exchange in May 1929, to refuse to list the corporation's Class A shares unless the Class B stockholders agreed to exercise only one-third of their voting power, that is, a quantum of voting power equal to that of the Class A stockholders, until 1,500,000 shares of Class A stock had been issued. On the happening of this event, the voting power of the two classes of stock would be equal. The Class B stockholders consented to this modification of their voting power in order to obtain the listing of the corporation's Class A shares (op. cit. supra, note 637, Commission's Exhibit No. 1908).

[643] Public Examination, American General Corporation et al., Commission's Exhibit No. X4194. Of the 20,000 shares of its own stock which it sold to the United Founders Corporation group, Insuranshares and General Management Company had acquired 10,000 from the Goldman Sachs Trading Corporation for $250,000 (ibid.). It will be recalled that at the formation of Insuranshares Corporation of Delaware, Insuranshares and General Management Company had acquired 450,000 shares of the Delaware company's Class B stock for $45,000.

or 7% of the 297,509 outstanding shares of Insuranshares and General Management Company which at that time held 475,000 shares, or 75% of the Class B stock of Insuranshares Corporation of Delaware.[644] By the end of 1931, Insuranshares and General Management Company had acquired the remaining 25,000 outstanding shares of the Class B stock of Insuranshares Corporation of Delaware.[645]

On May 27, 1931, Insuranshares Corporation of Delaware was recapitalized under a plan whereby the outstanding 750,000 shares of Class A stock were exchanged for 375,000 shares of common stock, and the outstanding Class B shares were similarly halved to create an issue of 250,000 Class B shares. The voting rights of the two classes of stock remained unchanged. As part of the recapitalization plan, the common stockholders were offered in July 1931, the right to subscribe to 93,750 additional shares of common stock at $9 a share in the ratio of one new share for each four shares then held by the stockholders.[646] By this offering, $843,750 of additional capital was raised by Insuranshares Corporation of Delaware.

The United Founders Corporation group of investment companies was engaged in accumulating additional stock in Insuranshares Corporation of Delaware and in Insuranshares and General Management Company which, as has been stated, controlled all of the Class B voting stock of Insuranshares Corporation of Delaware. By April 1932, the United Founders Corporation group had acquired 161,605 shares of the common stock of Insuranshares Corporation of Delaware, or 34% of the 468,750 shares of such stock then outstanding and 153,000 shares or 51% of the 297,509 shares of the capital stock of Insuranshares and General Management Company. The United Founders Corporation group, in fact, had an actual majority voting control of Insuranshares Corporation of Delaware, controlling 411,605 voting shares, or 57% of the 718,750 voting shares of the corporation.[647]

Although the United Founders Corporation group had voting control of Insuranshares Corporation of Delaware, only two of its representatives, George E. Devendorf and Erwin Rankin, were members of the directorate of the company, which consisted of 12 indi-

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[644] On March 5, 1930, Insuranshares and General Management Company had purchased from The Goldman Sachs Trading Corporation 25,000 shares of the Class B stock of Insuranshares Corporation of Delaware at a cost of $150,000 (op. cit. supra, note 637, Commission's Exhibit No. 1908).

[645] *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2508.

[646] Id., p. 2179. The new common stock was entitled to 85% of the corporate assets on liquidation of the company, and the new Class B stock was entitled to the residue of the corporation assets (ibid).

[647] The 161,605 shares of common stock of Insuranshares Corporation of Delaware in the election of directors had one vote a share multiplied by the number of directors to be elected. Through their voting control of Insuranshares and General Management Company, the United Founders Corporation group had the power to vote all of the 250,000 shares of the Class B stock of Insuranshares Corporation of Delaware which, although entitled by the company's charter to three votes a share multiplied by the number of directors to be elected, had been restricted to one vote a share as a condition to the listing of the company's common stock on the New York Curb Exchange and subsequently on the New York Stock Exchange until 750,000 shares of common stock had been issued. *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2510.)

viduals.[648] However, Mr. Devendorf was chairman of the investment committee of Insuranshares Corporation of Delaware.[649]

Insuranshares Corporation of Delaware did not fare well under the combined management of its original sponsors and the United Founders Corporation group. By April 1932, the net assets of the company had a market value of approximately $4,500,000, as compared with the $15,893,750 which had been contributed to the company by its stockholders.[650] In other words, the capital contributed to the company had depreciated in value by approximately $11,000,000 in the 3-year period of the company's active existence. The stockholder who had purchased his common stock at a cost of $43.75 a share in March 1929,[651] held a security which had an asset value of $8.30 [652] and a market value of $7 in April 1932.

However, the portfolio of Insuranshares Corporation of Delaware consisted of the dividend-paying securities of well-known insurance companies which had been purchased to hold "for the long pull." [653] Hobart Brown, a director of Insuranshares Corporation of Delaware, testified that the policy of the company's investment committee "was the investment from an investment standpoint and the question of marketability—in other words, not with the idea to buy these things and to sell them, to speculate in them, but to hold them." [654] The company had not invested its funds with a view to obtaining control of insurance companies. This policy of investment had been announced to the stockholders at the inception of the company and thereafter in its annual reports.[655]

This, then, was the situation of Insuranshares Corporation of Delaware in March and April 1932, when the Cohen group commenced to negotiate with the United Founders Corporation group of investment companies for the purchase by Insurance Equities Corporation of control of Insuranshares Corporation of Delaware. In the course of these negotiations, Mr. Menken and Mr. Cohen had made it clear to Mr. Devendorf, the new president of American Founders Corporation, that in contrast to the existing investment policy of Insuranshares Corporation of Delaware, the intention of the Cohen group after it acquired control of the company was to invest its funds in

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[648] In May 1932, when control of Insuranshares Corporation of Delaware passed to Insuranshares Equities Corporation, its board of directors consisted of Arthur P. Day, Joseph P. Harris, Edwin K. Hoover, Daniel Pierce, Sterling Pile (one of the original sponsors of the company), Edward B. Twombly (another of the original sponsors), Henry B. Twombly, C. Parker Kuhn, Hobart B. Brown, Edgar Boles, Erwin Rankin, and George E. Devendorf of the United Founders Corporation group of investment companies (op. cit. supra, note 568, at 207–8, 292).

[649] The investment committee of Insuranshares Corporation of Delaware consisted of Hobart B. Brown, Edward S. Goodwin, C. Parker Kuhn, and Mr. Devendorf, the chairman of the committee (ibid.).

[650] Public Examination, First Income Trading Corporation, et al., at 1063 and Commission's Exhibit No. 64.

[651] Each share of common stock had been issued in May 1931, in exchange for two shares of the former Class A stock of the company which had been sold to the public in March 1929, at $21⅞ a share.

[652] Op. cit. supra, note 568, at 475–6.

[653] Id., at 64, 276, 967.

[654] Id., at 70.

[655] The prospectus used in selling the securities of Insuranshares Corporation of Delaware to the public stated:

> It is the policy of the corporation adequately to diversify its holdings to include the securities of leading insurance companies engaged in writing life, fire, surety, casualty,

the purchase, in cooperation with Insurance Equities Corporation, of controlling blocks of the stocks of various life and casualty companies,[656] as a preliminary step to the merger and consolidation of such insurance companies.[657]

Furthermore, as Mr. Barnes conceded, the plan of the Cohen group for the merger and consolidation of insurance companies was venturesome, since it was probable that control of only insurance companies then in financial difficulties could be obtained by the Cohen group. Moreover, it would require a large reserve of funds to maintain the investments made in the insurance companies which were acquired. Mr. Barnes testified:[658]

Q. The program that has been referred to of acquiring a number of insurance companies and the consolidation or merger of them, the companies that were referred to were companies that either were in receivership or facing receivership or companies which were in a distressed condition. Isn't that correct in general?

A. Those were the only kind of companies for sale.

Q. And of course at the time they were not dividend paying investments, were they?

A. Some of them—Jefferson Standard, Shenandoah, Philadelphia Life—were all dividend payers.

Q. Large or small dividend payers?

A. Their dividends had been reduced from the normal.

Q. And the acquisition of control of any such companies required finances, didn't it?

A. Obviously.

Q. And if these companies were acquired, not at the market value of the company, but the liquidation value, which would take into effect every probable factor to the company, 40% of unearned premiums, every other bookkeeping factor, plus additional payments for control that would require substantial capital, wouldn't it?

A. It would introduce a hazard unless there was capital to protect it; yes.

Q. And in order to hold these companies beyond a point were the market, or earnings, would approach the price that was paid in these circumstances, it would require capital to hold, wouldn't it?

A. To insure against the hazards; yes.

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marine, and other classes of insurance and selected banks and trust companies in this country and abroad (op. cit. supra, note. 637, Commission's Exhibit No. 1908).

The annual report of Insuranshares Corporation of Delaware for the year ending December 31, 1931, stated:

> The decline in portfolio values during the year 1931 has been in sympathy with the general securities market, but as it has always been the policy of the management to buy investments for the portfolio and not securities for speculation, price changes may be ignored for the immediate future and interest concentrated on prospects over the longer term (op. cit. supra, note 568, at 68, and Commission's Exhibit No. 10).

[656] For a list of the insurance companies which the Cohen group contemplated acquiring see note 580, supra.

[657] Op. cit. supra, note 568, at 699 and 721. However, at one point Mr. Devendorf had been informed by S. Stanwood Menken, the attorney for Insurance Equities Corporation, that it was the intention of the Cohen group to invest only 25% of the assets of Insuranshares Corporation of Delaware in insurance companies in which the Cohen group was interested (id., at 664). Nevertheless, virtually all of the assets of Insuranshares Corporation of Delaware were invested in the acquisition of large blocks of the stocks of insurance companies which had a place in Mr. Cohen's plans for the amalgamation of insurance companies. (See infra, pp. 1209–25.)

[658] Op. cit. supra, note 568, at 1666–8.

Q. And it was then in your judgment a hazardous enterprise, wasn't it?

A. I would call it a venturesome enterprise, the whole plan.

Q. And without such resources such a program had very little opportunity for success; isn't that correct?

A. It was venturesome.

Although, as Mr. Barnes testified, the program which the Cohen group had in mind required a substantial amount of capital, Insurance Equities Corporation by May 3, 1932, when it acquired control of Insuranshares Corporation of Delaware, was virtually without funds. It will be recalled that all of the cash which Insurance Equities Corporation had received from the sale of its securities to North and South American Corporation had been expended in payments to the United Founders Corporation group of investment companies and Domestic & Foreign Investors Corporation, in the purchase of blocks of stock in Lloyds Casualty Company of New York and Detroit Fidelity and Surety Company and in payments to its attorneys, Menken, Ferguson and Hill, and Sherman and Goldring.[659] Furthermore, in April 1932 Insurance Equities Corporation had borrowed $70,000 from J. A. Sisto & Company on the collateral security of the stocks of Lloyds Casualty Company of New York and Detroit Fidelity and Surety Company, which it owned.[660] By the end of April 1932 substantially all these borrowed funds had been disbursed by Insurance Equities Corporation to repay its $20,000 indebtedness to American Founders Corporation incurred in connection with the acquisition of control of North and South American Corporation and in advances to Lloyds Casualty Company and to a company controlled by Frank Cohen.[661] On May 3, 1932, Insurance Equities Corporation had an actual cash position of only $2,779,[662] and in fact its liabilities then exceeded the market value of its assets.[663]

As will be described later, the contract price for the purchase of control of Insuranshares Corporation of Delaware exceeded $2,000,000, of which $450,000 in cash was to be paid immediately and the remainder was to be paid in installments. Insurance Equities Corporation clearly was not in a financial position to pay this sum in April 1932. However, Mr. Cohen intended to use the assets of In-

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[659] See supra, pp. 1191–2.

[660] Op. cit. supra, note 568, at 532–3.

[661] Id., at 528; see supra, pp. 1188–9.

[662] Op. cit. supra, note 568, at 630, 1320–1, and 1327. Of the $70,000 borrowed by Insurance Equities Corporation from J. A. Sisto & Company, $65,000 was expended as follows: The loan of $20,000 obtained from United Founders Corporation was repaid; $30,000 was advanced to Motor Vehicle Underwriters, a company controlled by Cohen, as the purchase price of additional blocks of the stock of Lloyds Casualty Company of New York; and $15,000 was advanced to Lloyds Casualty Company of New York (ibid). The remaining $5,000 of the $70,000 of borrowed funds was in part used by Insurance Equities Corporation to pay miscellaneous expenses. On May 3, 1932, Insurance Equities Corporation had only $2,779 of actual cash on hand (id., at 530).

[663] Insurance Equities Corporation, on May 3, 1932, owed $70,000 to J. A. Sisto & Company. Its assets consisted of its holdings of North and South American Corporation stock having an asset value of $11,000 (see note 619, supra), $2,779 in cash, 10,000 shares of Lloyds Casualty Company, with a market value of $20,000, and 4,000 shares of Lloyds Casualty Company, having a market value of $28,000. Insurance Equities Corporation thus had total assets having a market value of approximately $62,000 (op. cit. supra, note 568, at 533).

suranshares Corporation of Delaware both to pay for its control and to further his program for the acquisition of control and the consolidation of Insurance companies. Mr. Cohen testified that the same method which was used by Insurance Equities Corporation to acquire control of North and South American Corporation was to be applied in the case of Insuranshares Corporation of Delaware:[664]

Q. On May 3, 1932, you know, don't you, that Insurance Equities Corporation had in its portfolio 4,000 shares of Detroit Fidelity & Surety Company and 10,000 shares of Lloyds Casualty Company of New York which were pledged as security for a loan, it had the shares of North and South American relating to its domestic securities and which company had at that time as the total value of its domestic securities $6,000; and it had between two and three thousand dollars in the bank altogether. Insurance Equities was to pay American Founders, wasn't it, by getting the money from Insuranshares through having Insuranshares subscribe to the preferred and common stock of Equities as it had done in North and South American; isn't that a fact?

A. Insuranshares was to buy preferred stock of the Insurance Equities.

Q. And the money which it was to get from Insuranshares was to be used in part at least to make this first payment of $450,000 to American Founders?

A. The proceeds of the preferred stock would be used to pay for the stock; yes.

* * * * * * *

A. We never would have bought Insuranshares if they wouldn't buy preferred stock of the Insurance Equities, if that is what you mean.

Q. Insurance Equities had no means of financing this purchase otherwise; that is true, isn't it at this time?

A. We were going to do it by the preferred stock.

Although the United Founders Corporation companies were unaware[665] of the plan by which Mr. Cohen intended to procure the funds to pay for control of Insuranshares Corporation of Delaware, they took no steps to investigate the financial status of Insurance Equities Corporation during the course of the negotiations by that corporation for the purchase of control of Insuranshares Corporation of Delaware. They did not demand any balance sheet of Insurance Equities Corporation.[666] The United Founders Corporation group relied solely on the oral declarations of the Cohen group that they had resources in excess of $5,000,000.[667]

Although the investment policy which the Cohen group intended to pursue with the assets of Insuranshares Corporation of Delaware was, as Mr. Barnes testified, a "venturesome one," totally at variance with the company's existing investment policy, the United Founders Corporation group took no steps to inform the stockholders of Insuranshares Corporation of Delaware of the prospective shift in the

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[664] Id., at 1259, 1274.

[665] Id., at 1395.

[666] Id., at 619. It will be recalled that in the case of North and South American Corporation no investigation had been made by the United Founders Corporation group of investment companies of the financial resources of Insurance Equities Corporation because, as Mr. Devendorf testified, the United Founders Corporation group was to receive a single cash payment for the control of North and South American Corporation (ibid.). In the case of Insuranshares Corporation of Delaware payment was to be made in installments. (See infra, p. 1203.)

[667] Id., at 699, 1388.

control of their assets and of the policies which the new controlling group intended to adopt.[668]

Despite the fact that the stockholders of Insuranshares Corporation of Delaware had presumably invested in and retained their stock in the company in reliance on the continuance of its existing investment policy, Mr. Seagrave, the president of American Founders Corporation, testified that any change of the investment policy of the company was a matter solely for the determination of the Cohen group after it acquired control: [669]

> Q. Were you particularly concerned with whether or not the purchasers, when they came in later, would want to change the policy of the company?
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> A. Well, I don't believe that I was particularly concerned. I was told in advance of any need for concern, they had various insurance companies which they intended to put together and that they wanted to acquire this company [Insuranshares Corporation of Delaware] which was in that field. The question of whether they would change a policy or not was a question of their determination from time to time.

As has been stated, during the course of the negotiations between the Cohen group and the United Founders Corporation companies in connection with purchase of control of Insuranshares Corporation of Delaware, the United Founders Corporation group made no attempt to investigate the financial condition of Insurance Equities Corporation. Nor were the officials of the United Founders Corporation group made suspicious by a request made by the Cohen group that Insuranshares Corporation of Delaware realize, by the liquidation of part of its portfolio, $1,000,000 in cash prior to the closing of any contract for the passage of control of the company to the Cohen group. Mr. Devendorf testified that this request was made by the Cohen group in order that Insuranshares Corporation of Delaware have funds available, on the passage of its control to the Cohen group, for immediate investment in insurance companies in which the Cohen group was interested or about to become interested.[670] This request was embodied in one of the covenants in a draft contract for the purchase of control of Insuranshares Corporation of Delaware prepared by the Cohen group on April 13, 1932.[671] The United Founders Corporation group, however, refused to accede to any such covenant in the contract, and the final contract did not contain any such posi-

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[668] At the insistence of Edward B. Twombly, one of the original sponsors of Insuranshares Corporation of Delaware, the Cohen group, on June 14, 1932, after it had been in control of Insuranshares Corporation for more than a month, informed the company's stockholders of the change in its management and of the investment policy which the Cohen group intended to follow (id., at 419; *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2509). However, by June 14, 1929, approximately $900,000 of the total assets of $4,500,000 owned by Insuranshares Corporation of Delaware had been expended in the purchase of blocks of the stock of Insurance Equities Corporation and of Constitution Indemnity Company, both of which blocks subsequently became worthless. (See infra, pp. 1206–12.)

[669] Op. cit. supra, note 568, at 1460.

[670] Id., at 630.

[671] Id., at 671. The provision in the draft contract was as follows:

> Such purchase shall be made with the understanding that you will liquidate and turn into cash to the extent of a million dollars part of the portfolio of the Insuranshares Corporation of Delaware (ibid.).

tion. Mr. Devendorf, vice president of American Founders Corporation, testified:[672]

Q. You didn't want that provision in the contract, did you?

A. We didn't want it in the contract or agree to it in any form.

Q. But you wanted, if you could, to have a million available for the new group, didn't you?

A. No.

Q. Weren't you concerned about attempting to meet their desire and to have cash on hand?

A. Yes.

Q. And did you try to do what you could to have on hand the cash which they wanted?

A. Insofar as the rest of the committee of Insuranshares Corporation of Delaware were willing to agree with me, as being a move to the interest of Delaware, yes.

Although the United Founders Corporation group refused to permit the existence of any written agreement to liquidate the portfolio of Insuranshares Corporation of Delaware to the extent of $1,000,000, Mr. Devendorf testified that it was his independent opinion, based on existing market conditions for insurance company stocks, that Insuranshares Corporation of Delaware should convert a substantial portion of its portfolio into cash.[673] However, he was aware that the Cohen group intended to invest any cash assets of Insuranshares Corporation of Delaware in the stock of insurance companies in which the Cohen group was interested.

On April 14, 1932, Mr. Devendorf, as the chairman of the investment committee of Insuranshares Corporation of Delaware, recommended a liquidation by the company of a portion of its portfolio sufficient to realize from $600,000 to $1,000,000.[674] Mr. Devendorf based his recommendations on "economic conditions and the condition of the market," but did not recommend the sale of any particular securities.[675] However, Mr. Devendorf did not reveal to the members of the investment committee that the United Founders Corporation group of investment companies were contemplating the sale of their control of Insuranshares Corporation of Delaware to Insurance Equities Corporation.[676]

Hobart Brown, a member of the investment committee of Insuranshares Corporation of Delaware, testified that:[677]

We had every reason to have confidence in Mr. Devendorf and the committee did agree to sell some securities and Mr. Goodwin prepared a list.

Mr. Brown also testified[678] that the portfolio securities selected by Mr. Goodwin were ones which were "lacking in merit"[679] as investments but which were also easily marketable:

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[672] Id., at 626.

[673] Id., at 632.

[674] Id., at 79, 628.

[675] Id., at 182, 185.

[676] Id., at 81.

[677] Id., at 79.

[678] Id., at 86–8.

[679] Id., at 184. Mr. Brown also testified that prior to April 1932, all sales of portfolio securities were made either to derive funds for the payment of dividends or to procure funds for reinvestment in other securities selected from an investment standpoint (id., at 262–4).

Q. They were selected, you say, because it was the view of the committee that the market would best support a sale of such shares in blocks?

A. I would say that was correct.

By May 3, 1932, when control of Insuranshares Corporation of Delaware was obtained by Insurance Equities Corporation, a portion of the portfolio of Insuranshares Corporation of Delaware had been liquidated for cash proceeds of $360,833.42.[680] The use made of these funds by Insurance Equities Corporation will be described later.

Meanwhile, on April 21, 1932, Insurance Equities Corporation had entered into a contract [681] to purchase from the United Founders Corporation group of investment companies 153,000 shares of the capital stock of Insuranshares & General Management Company at $2.50 a share, 161,605 shares of the common stock of Insuranshares Corporation of Delaware at an average price of $8.89 a share,[682] and 64,497 shares of the common stock of Insuranshares Certificates, Inc.[683] at a price of $3.25 a share. The total purchase price of all of these securities was $2,028,917.25.

The stock of Insuranshares & General Management Company and of Insuranshares Corporation of Delaware was to be paid for in installments as follows: $450,000 on the date of the closing of the contract, which occurred on May 3, 1932; $550,004 on May 31, 1932; and $819,297 on July 31, 1932. The United Founders Corporation group of companies was to retain the stock of Insuranshares & General Management Company as security for the payment of the installments and was to release such stock only after the receipt of full payment for all of the securities which were to be sold.[684] The stock of Insuranshares Corporation of Delaware, however, was to be released by the United Founders Corporation group of companies to Insurance Equities Corporation at the rate of one share for each $9 of payments made by Insurance Equities Corporation.

The payment for the stock of Insuranshares Certificates, Inc., was to be made within 60 days after the closing of the contract between the parties.

The United Founders Corporation group also agreed to deliver at the closing the resignation of all of the officers and 8 of the 12 directors of Insuranshares Corporation of Delaware and all of the officers and 9 of the 10 directors of Insuranshares & General Management Company. The United Founders Corporation group also agreed to cause the representatives of Insurance Equities Corporation to be elected as officers and directors of the two companies to fill the vacan-

[680] Op. cit, supra, note 650, Commission's Exhibit No. 99. Mr. Brown testified that the portfolio securities were sold as fast as the market permitted and that Mr. Devendorf had protested that the sales "weren't going fast enough" (op. cit. supra, note 568, at 91).

[681] Op. cit. supra, note 650, Commission's Exhibit No. 98.

[682] Of the 161,605 shares of the common stock of Insuranshares Corporation of Delaware, 70,572 were to be purchased by Insurance Equities Corporation at a price of $8.75 a share and 91,033 shares were to be purchased at $9 a share (ibid.).

[683] Insuranshares Certificates, Inc. had been formed in Maryland on October 15, 1929, by the same group which had originally sponsored Insuranshares Corporation of Delaware (op. cit. supra, note 640, at 5031–2) as a consolidation of five fixed investment trusts which had previously been sponsored by the same group (*Moody's Manual of Investments, Banks, etc.*, 1933, p. 2510). In April 1932, Insuranshares Certificates, Inc. had outstanding 894,539 shares of capital stock 'ibid.), so that the 64,497 shares of such stock which Insurance Equities Corporation had agreed to purchase from the United Founders Corporation group did not represent control of Insuranshares Certificates, Inc.

[684] Op. cit. supra, note 650, Commisson's Exhibit No. 98.

cies created by the resignations. By this procedure the United Founders Corporation group would place Insurance Equities Corporation in effective control of the management and of the funds of both Insuranshares Corporation of Delaware and of Insuranshares & General Management Company.

However, the contract contained an agreement by Insurance Equities Corporation to cause the resignation of its own representatives and the election of representatives of the United Founders Corporation group of companies to the offices and directorates of Insuranshares Corporation of Delaware and of Insuranshares & General Management Company in the event that Insurance Equities Corporation defaulted in any of the installment payments on its purchase contract.

The United Founders Corporation group had obtained an advantageous price for their sale of control of Insuranshares Corporation of Delaware.[685] They had a contract to sell 161,605 shares of the common stock of Insuranshares Corporation of Delaware at an average price of $8.89 a share, although on April 22, 1932, the asset value of such stock was $8.30 a share on the basis of the bid market price of the company's portfolio of securities on that day.[686] The market price of the stock on the same day was $7 a share. The United Founders Corporation group had thus disposed of their holdings of the common stock of Insuranshares Corporation of Delaware at an aggregate price of $305,433.45 in excess of the market value and $95,346.95 in excess of the asset value of such stock. Similarly, the 153,000 shares of the stock of Insuranshares & General Management Company which the United Founders Corporation group sold at a price of $2.50 a share had an asset value of $1.90 [687] a share and a market value of $1 a share. The United Founders Corporation group obtained for their holdings of this stock a price which exceeded the asset value of such stock by approximately $92,000 and its market value by $229,500. The United Founders Corporation group's holdings of the 64,497 shares of Insuranshares Certificates, Inc., were sold at a price approximately $34,000 less than their asset value.[688] However, the price obtained for such stock by the United Founders Corporation group from Insurance Equities Corporation exceeded the market value of the stock by $64,497.[689]

For all of the securities sold by the United Founders Corporation group to Insurance Equities Corporation, they were to obtain an aggregate price which exceeded the market value of the securities by $609,430,[690] and which exceeded the aggregate asset value of such securities by approximately $153,000.

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685 Edward B. Twombly, one of the original sponsors of Insuranshares Corporation of Delaware, testified that in his opinion the United Founders Corporation group of investment companies had obtained a "good price" for their holdings of the common stock of Insuranshares Corporation of Delaware and for their minority holdings of Insuranshares Certificates, Inc. (op. cit. supra, note 568, at 415, 426).

686 Id., at 476.

687 This asset value is at December 31, 1931 (*Moody's Manual of Investments, Banks, etc.*, 1933, p. 2508).

688 As at April 22, 1932, the asset value of the stock of Insuranshares Certificates, Inc., based on the bid market prices of its portfolio on that day, was $3.78 a share (op. cit. supra, note 568, at 476). The price Insurance Equities Corporation agreed to pay for the stock was $3.25 a share.

689 The market value of the stock of Insuranshares Certificates, Inc., on April 21, 1932, was $2.25 a share.

690 Op. cit. supra, note 568, Exhibit No. 22.

On May 3, 1932, the closing of the contract for the purchase of control of Insuranshares Corporation of Delaware by Insurance Equities Corporation took place. Before receiving the $450,000 down payment required by the contract, the United Founders Corporation group of investment companies caused 8 of the 12 directors of Insuranshares Corporation of Delaware to resign [691] and to be replaced by representatives of Insurance Equities Corporation.[692] C. Parker Kuhn, Hobart B. Brown, Edward B. Twombly, and Edgar Boles of the existing board of directors of Insuranshares Corporation of Delaware, continued in their positions in order to protect minority interests.[693]

Murray Taylor, the attorney for the United Founders Corporation group of investment companies, conceded that control of the management of Insuranshares Corporation of Delaware was turned over to Insurance Equities Corporation before the United Founders Corporation group had received any payment from Insurance Equities Corporation. Mr. Taylor testified:[694]

> Q. Now, on the May 3 closing, it is equally true, isn't it, that you did not see the certified check before the directors of the corporation resigned and the nominees of Insurance Equities were elected in their place?
>
> A. That is true.

The control of the directorate of Insuranshares Corporation of Delaware was thus gratuitously placed in the hands of Insurance Equities Corporation. Over the protest of Mr. Twombly and Mr. Kuhn,[695] two of the minority directors, the eight representatives of Insurance Equities Corporation, immediately after they were elected as directors of Insuranshares Corporation of Delaware, voted to

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[691] The directors who resigned were Arthur P. Day, Joseph P. Harris, Edwin K. Hoover, Daniel Pierce, Sterling Pile, Henry B. Twombly, Erwin Rankin, and George E. Devendorf. Edward B. Twombly, one of the original founders of the company, at the request of Mr. Devendorf, procured the resignation of several of these directors (id., at 289), because he felt they would be deposed at the next annual meeting (which was to occur on May 10, 1932) anyway and he wanted to expedite matters (id., at 336).

[692] The directors elected as representatives of Insurance Equities Corporation were: Julius H. Barnes, who became the chairman of the board of directors of Insuranshares Corporation of Delaware, Franklin Berwin, Esmond P. O'Brien, Griswold Daniell, Edward C. Denby, Kenneth Gayle, Carl Sherman and Victor Sincere (id., at 207–9).

[693] On May 2, 1932, Edward B. Twombly had asked Mr. Devendorf to request the Cohen group to permit several of the existing directors to remain to represent minorities, and the Cohen group had agreed to this request (id., at 291–2). Mr. Twombly, as a director of Insuranshares Corporation of Delaware, opposed all of the later transactions between Insurance Equities Corporation and Insuranshares Corporation of Delaware (id., at 312). Messrs. Twombly, Brown, Kuhn and Boles resigned as directors of Insuranshares Corporation of Delaware in December 1932, when Mr. Twombly felt he could no longer "be effective on behalf of the minority group" (id., at 327 and 232). On March 23, 1933, Mr. Twombly and Mr. Brown filed a complaint with the Attorney General of the State of New York with reference to the activities of Insurance Equities Corporation in the management of Insuranshares Corporation of Delaware, but the Attorney General took no action on the complaint (id., at 255–6, 327).

[694] Id., at 1581.

[695] Mr. Kuhn and Mr. Twombly inquired about the necessity for the loan, and Mr. Twombly testified:

> They said they had plans, development plans that they wanted to invest in a company in which they were interested, that they would not want to liquidate the portfolio. They wanted to make a loan so that they could make an investment which had to be made immediately. Both Mr. Kuhn and I objected on the ground that we didn't consider the company should be operated in that way; that future funds from the sale of securities should be anticipated and borrowing made; we objected to the borrowing on principle and they said it was part of their plans; so Mr. Kuhn and I merely did not vote (id., at 295).

borrow $300,000 from the National City Bank of New York, to be secured by portfolio securities of Insuranshares Corporation of Delaware which the bank was empowered to liquidate to satisfy its loan. A representative of the bank present at the meeting turned over the bank's check for $300,000 and received portfolio securities of Insuranshares Corporation of Delaware as collateral for the loan.[696]

It will be recalled that Insuranshares Corporation of Delaware had derived cash proceeds of $360,833[697] as the result of the liquidation of a portion of its portfolio securities between April 14, 1932, and May 3, 1932. The $300,000 loan thus increased the company's available cash to $660,833.

Immediately following the passage of the resolution to borrow $300,000, the Cohen group representatives on the directorate of Insuranshares Corporation of Delaware, over the protests of Edward B. Twombly and C. Parker Kuhn, two of the minority directors, adopted a resolution to authorize the purchase at a cost of $651,300 of 6,500 shares of the preferred and 13,000 shares of the common stock of Insurance Equities Corporation.[698] Mr. Twombly and Mr. Kuhn futilely voted against the purchase after their demand for a financial statement of Insurance Equities Corporation had been denied.[699] Mr. Twombly also contended that the investment in the securities of Insurance Equities Corporation was a violation of the charter of Insuranshares Corporation of Delaware which prohibited the investment of more than 10% of the assets of the company in the securities of any other company[700] with the exception of a company engaged in a type of business similar to that of Insuranshares Corporation of Delaware. Mr. Twombly argued that Insurance Equities Corporation which was engaged in acquiring control of insurance companies was engaged in a business dissimilar to that of Insuranshares Corporation of Delaware which, prior to the advent of the Cohen group, had only invested in minority blocks of the stocks of insurance companies.[701]

Murray Taylor, the counsel for the United Founders Corporation group of investment companies, who had remained at the meeting to obtain the down payment of $450,000 from Insurance Equities Corporation required by its purchase contract with the United Founders Corporation group of investment companies, witnessed

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[696] On May 2, 1932, Franklin Berwin of the Cohen group had arranged this loan with the National City Bank (id., at 1626–7).

[697] Op. cit. supra, note 650, Commission's Exhibit No. 99.

[698] Op. cit. supra, note 568, at 303–4 and Exhibit No. 25A.

[699] Mr. Twombly testified that he "complained that the directors had no right to invest in any organization as to which they were not fully apprised both as to the security they were buying and what the statement of the company showed" (id., at 304). The Cohen group promised to submit a financial statement of Insurance Equities Corporation to the board of directors of Insuranshares Corporation of Delaware at a later date.

[700] The then assets of Insuranshares Corporation of Delaware had a value of approximately $4,500,000. The investment of $651,300 made in the securities of Insurance Equities Corporation thus exceeded 10% of the value of the assets of Insuranshares Corporation of Delaware.

[701] Op. cit. supra, note 568, at 309 and 348–9. Mr. Twombly testified:

> I told him [Menken] that I thought it was an entirely improper transaction to invest the money of Insuranshares Corporation of Delaware in the stock of a so-called parent company. I protested that it was a direct violation of the provisions of the certificate of incorporation. I told him that steps would have to be taken promptly to undo the transaction or to substitute other securities for it (id., at 309).

without protest this purchase by Insuranshares Corporation of Delaware of the securities of Insurance Equities Corporation.[702]

As a result of the sale of its securities to Insuranshares Corporation of Delaware, Insurance Equities Corporation derived $651,300 of funds. Late in the afternoon of May 3, 1932, Insurance Equities Corporation turned over to Mr. Taylor, the attorney for the United Founders Corporation group, a certified check for $450,000 as the down payment of its purchase of control of Insuranshares Corporation of Delaware.[703] Thus, the United Founders Corporation group of companies received in part payment for their sale of control of Insuranshares Corporation of Delaware, $450,000 in cash which was derived from the assets of Insuranshares Corporation of Delaware itself. George E. Devendorf, although he denied that the United Founders Corporation group had been previously aware of the fact that the Cohen group intended to use the assets of Insuranshares Corporation of Delaware to pay for its control,[704] admitted that the United Founders Corporation group of investment companies had actually been paid a large part of the price for its sale of control of Insuranshares Corporation of Delaware with the assets of that corporation itself. Mr. Devendorf testified:[705]

Q. Now, Insuranshares Corporation of Delaware, that had a pretty unfortunate experience, too, did it not?

A. Well, it didn't have a very unfortunate experience in its investments, it had an unfortunate experience in its change of sponsorship.

Q. That is new management came in and then things happened; isn't that so?

A. That is correct.

* * * * * * *

Q. Did you participate in the negotiations which looked forward to the sale of control of Insuranshares Corp. of Delaware, by the Founders group to the * * * two new sponsors, Barnes and Frank Cohen?

A. Yes.

Q. And after Barnes and Cohen got into that picture they had bought control of Insuranshares Corp. of Delaware from the Founders on the installment plan; isn't that so?

A. On time payments.

Q. You are not squeamish about "installment plan" are you?

A. No.

Q. It subsequently turned out that Mr. Barnes and Mr. Cohen made those payments with receipts that they had obtained from the sale of securities to Insuranshares Corp. of Delaware; isn't that so?

A. At least partly; yes.

Q. At least a good part of it, isn't that so?

A. I don't remember just what part of it it was.

Substantially all of the remaining $201,300 of the $651,300 which Insurance Equities Corporation had derived from the sale of its securities to Insuranshares Corporation of Delaware, were disbursed by Insurance Equities Corporation by May 10, 1932. J. A. Sisto & Company received $40,000 in partial repayment of its $70,000 loan

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[702] Id., at 1555–7. After hearing the resolution to make the purchase, Mr. Taylor remarked to Mr. Twombly, "that sounds like an upstream investment" (ibid.).

[703] Id., at 544, 1555–7.

[704] Id., at 334.

[705] Public Examination, General Investment Corporation, at 15046–7.

to Insurance Equities Corporation; $50,000 was paid to Frederic P. Robert, of E. A. Pierce & Company, for his services as a "finder" of Insuranshares Corporation of Delaware for Insurance Equities Corporation; Menken, Ferguson and Hill received $15,000 for legal services; Sherman and Goldring received $10,000 for legal services; $17,000 was advanced to Frank Cohen ostensibly for the delivery of further shares of the stock of Lloyds Casualty Company of New York and of Detroit Fidelity and Surety Company; $2,500 was advanced to Franklin Berwin, a member of the Cohen group; $7,500 was advanced to Lloyds Casualty Company of New York; the remainder of the funds were used to purchase various other securities. At May 10, 1932 Insurance Equities Corporation had a cash balance of about $1,500.[706]

At the insistence of Mr. Twombly, the Cohen group promised to substitute for the securities of Insurance Equities Corporation, at some later date, the stock of Lloyds Insurance Company of America, a company which the group intended to form as a consolidation of Lloyds Casualty Company, Detroit Fidelity and Surety Company, and other casualty insurance companies.[707] However, on June 10, 1932, there were removed from the portfolio of Insuranshares Corporation of Delaware 2,880 shares of the preferred and 2,310 shares of the common stock of Insurance Equities Corporation in exchange for 96,077 shares of the capital stock of Insuranshares Certificates, Inc., held by Insuranshares & General Management Company.[708] The blocks of Insurance Equities Corporation stock involved in the "intercompany" exchange had cost Insuranshares Corporation of Delaware $288,231.[709] The Insuranshares Certificates, Inc., stock received by Insuranshares Corporation of Delaware for the stock of Insurance Equities Corporation had a market value $96,077 [710] less than the cost of the stock of Insurance Equities Corporation. In other words, the exchange resulted in a loss to Insuranshares Corporation of Delaware of approximately $96,077. Subsequently, however, Insurance Equities Corporation removed these and other shares of Insuranshares Certificates, Inc., from the portfolio of Insuranshares Corporation of Delaware as part of a series of transactions by which various securities [711] held by Insuranshares Corporation of Delaware were delivered to Insurance Equities Corporation in exchange for common stock of Insuranshares Corporation of Delaware itself. These transactions will be described in detail later.

On December 31, 1933, the date when the Cohen group control of Insuranshares Corporation of Delaware terminated, that company still had in its portfolio 2,777 shares of the preferred stock and 9,442 shares of the common stock of Insurance Equities Corporation.[712]

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[706] Op. cit. supra, note 568, at 544, 816.

[707] Mr. Twombly testified:

> * * * we eventually obtained an agreement, a gentlemen's agreement by the controlling parties that they would eliminate Insurance Equities stock from the portfolio and substitute the stock of a new company to be formed, called Lloyds Casualty Company of America (id., at 309).

[708] Id., Exhibit No. 138.

[709] Id., at 889, 1687 (testimony of Julius H. Barnes).

[710] Ibid.

[711] These securities removed from the portfolio of Insuranshares Corporation of Delaware in exchange for its own stock included 43 shares of the preferred and 1,248 shares of the common stock of Insurance Equities Corporation itself.

[712] *Moody's Manual of Investments, Banks, etc.*, 1934, p. 2699.

These remaining shares of the stock of Insurance Equities Corporation had cost Insuranshares Corporation of Delaware $278,644. On February 13, 1934, Insurance Equities Corporation, which was then insolvent, was placed in receivership.[713] The securities of Insurance Equities Corporation then held by Insuranshares Corporation of Delaware thus became worthless.[714]

From the moment it had acquired control of Insuranshares Corporation of Delaware, Insurance Equities Corporation began to liquidate the portfolio of Insuranshares Corporation in order to provide cash for further payments on its purchase obligation to the United Founders Corporation group of investment companies and to provide funds to be invested by Insuranshares Corporation of Delaware in furtherance of Mr. Cohen's plan for the consolidation and merger of various insurance companies.[715] Between April 1932 and December 1933, when the Cohen group lost control of Insuranshares Corporation of Delaware, that company sold nearly its entire portfolio of securities for proceeds of approximately $4,500,000 in cash.[716] Based on the cost of the securities sold, Insuranshares Corporation of Delaware, as a result of the liquidation of its portfolio, suffered a realized loss of approximately $11,800,000.[717] The funds realized by the sale of the company's portfolio were nearly all reinvested in the stocks of insurance companies acquired from or through Insurance Equities Corporation at prices in excess of the market prices of the securities or in companies in which Frank Cohen was interested.

In several of these transactions Insurance Equities Corporation was enabled to derive funds to meet nearly all of the installment payments due to the United Founders Corporation group of investment companies on the purchase price of control of Insuranshares Corporation of Delaware.

On May 31, 1932, there was due the United Founders Corporation group by Insurance Equities Corporation an installment payment of $550,004. At that date Insurance Equities Corporation had a cash balance in banks of $453.[718] Insurance Equities Corporation failed to meet its installment payments to United Founders Corporation group on May 31, 1932. However, as a result of a series of transactions between Insuranshares Corporation of Delaware, Insurance Equities Corporation and two insurance companies under the control of Insurance Equities Corporation, the latter company, by June 10, 1932, derived $306,000 which it paid over to the United Founders Corporation group in partial satisfaction of the $550,004 due them on May 31, 1932.

Prior to May 31, 1932, Insurance Equities Corporation had borrowed $500,000[719] from the National City Bank of New York and had purchased at a price of $5 a share all of the outstanding 100,000 shares of capital stock of Constitution Indemnity Company of Phila-

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[713] Id., 1935, p. 1597.

[714] As at December 31, 1933, Insuranshares Corporation of Delaware had written its investment in the stock of Insurance Equities Corporation down to $1 (ibid.).

[715] See supra, pp. 1197–99.

[716] Op. cit. supra, note 650, Commission's Exhibit No. 99.

[717] Ibid.

[718] Op. cit. supra, note 568, at 832–3.

[719] Id., at 1695.

delphia.[720] Insurance Equities Corporation had transferred 45,000 shares of the stock of Constitution Indemnity Company to Lloyds Casualty Company of New York for $225,000.[721]

However, on June 6, 1932, Insuranshares Corporation of Delaware acquired, by purchase from Insurance Equities Corporation, 45,000 shares of the stock of Constitution Indemnity Company at a price of $225,000 plus a "loading charge" [722] of $22,500 or a total price of $247,500.[723]

Edward B. Twombly, C. Parker Kuhn, and Edgar Boles, the minority directors of Insuranshares Corporation of Delaware, objected to the purchase by the company of the 45,000 shares of the stock of Constitution Indemnity Company on the ground that, as Mr. Barnes testified, "they had grave doubts as to the value of the stock to be purchased." [724]

At the same time that Insurance Equities Corporation derived $247,500 from the sale of the stock of Constitution Indemnity Company to Insuranshares Corporation of Delaware, Insurance Equities Corporation sold to Constitution Indemnity Company, which it controlled, 57,000 shares of the common stock of Insuranshares Corporation of Delaware at $8.75 a share or a total price of $498,750. This price, paid by Constitution Indemnity Company, was approximately $235,000 in excess of the then market price of the stock of Insuranshares Corporation of Delaware.[725]

From these transactions with its controlled companies, Insurance Equities Corporation derived a total of $746,250. Of these funds, $306,000 was paid to the United Founders Corporation group in partial satisfaction of the installment payment of $550,004 which had

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[720] Ibid. The stock of Constitution Indemnity Company had been acquired from the Fire Association of Philadelphia (id., at 1140). Frank Cohen, Percy H. Biglin, Franklin Berwin and Carl Sherman became directors of Constitution Indemnity Company (id., at 831–2). In addition, Esmond P. O'Brien, a representative of the Cohen group on the directorate of Insuranshares Corporation of Delaware, also became a director of Constitution Indemnity Company (ibid.).

[721] Id., at 1141. The remaining 55,000 shares of the stock of Constitution Indemnity Company plus 25,000 shares of the stock of Lloyds Casualty Company had been deposited with the National City Bank as security for the loan which it had made to Insurance Equities Corporation to enable it to purchase the stock of Constitution Indemnity Company (id., at 1695).

[722] Id., at 1076. Mr. Barnes testified that this and other "loading charges" required of Insuranshares Corporation of Delaware in connection with the purchase of securities from Insurance Equities Corporation were fixed at 10% of the cost of the securities sold to Insurance Equities Corporation and were intended to defray the expenses of Insurance Equities Corporation attendant on its investigation of insurance companies over which it was seeking control (id., at 1658). A total of $182,727 was ultimately derived by Insurance Equities Corporation as "loading charges" on securities sold to Insuranshares Corporation of Delaware (id., at 1076). However, the total expenses of Insurance Equities Corporation, from May 1932 to October 1933, did not exceed $117,000 (id., at 1081 and 1089).

[723] Id., at 822–3.

[724] Id., at 1670. For the year 1930, the combined loss on underwritings and investments suffered by Constitution Indemnity Company was $1,071,403; in 1931 such loss totaled $889,518. The company's ratio of losses to premiums earned for 1930 was 72.17%. For 1931 the ratio was 68.55%. The company had paid no dividends after July 1, 1930 (*Moody's Manual of Investments, Banks, etc.*, 1932, p. 1908).

[725] Op. cit. supra, note 568, at 827–9. The highest market price for the common stock of Insuranshares Corporation of Delaware, in June 1932, was $4.63 a share, or a total market price of $264,000 for the 57,000 shares of such stock acquired by Constitution Indemnity Company.

been payable on May 31, 1932, to the United Founders Corporation group by Insurance Equities Corporation. The Founders companies, on the receipt of this payment, released 34,000 shares of the stock of Insuranshares Corporation of Delaware to Insurance Equities Corporation.[726] These shares of the stock of Insuranshares Corporation of Delaware, together with 23,000 additional shares of such stock which Insurance Equities Corporation had purchased from Allied General Corporation at $4.75 [727] a share, or a total price of $119,250, were delivered to Constitution Indemnity Company by Insurance Equities Corporation.

Finally, Insurance Equities Corporation paid $225,000 to Lloyds Casualty Company of New York and received 45,000 shares of the stock of Constitution Indemnity Company, which were delivered by Insurance Equities Corporation to Insuranshares Corporation of Delaware. It will be recalled that Insuranshares Corporation of Delaware had agreed to pay and had paid $247,500 for these shares.

On November 4, 1932, the Cohen group effected a consolidation [728] of Lloyds Casualty Company of New York, Detroit Fidelity and Surety Company, and Constitution Indemnity Company, all of which had suffered large losses on their underwritings and investments in 1930 and 1931.[729] Under the terms of the merger, Insuranshares Corporation of Delaware acquired 18,000 shares of the new company, Lloyds Insurance Company of America, in exchange for its holdings of 45,000 shares of the stock of Constitution Indemnity Company.[730]

The consolidated company, Lloyds Insurance Company of America, did not fare well. On August 4, 1933, within eight months after the formation of the company, the Insurance Department of the State of New York placed Lloyds Insurance Company of America in liquidation.[731] As a consequence, Insuranshares Corporation of Delaware

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[726] Id., at 827–9.

[727] Ibid. In June 1932, Allied General Corporation, which under its former name of Insuranshares Corporation of New York had distributed the stock of Insuranshares Corporation of Delaware to the public in 1929 (see supra), had agreed to sell 43,000 shares of the common stock of Insuranshares Corporation of Delaware to Insurance Equities Corporation. Insurance Equities Corporation was to purchase these shares on an installment plan of payments (id., at 359 and op. cit. supra, note 640, at 5284).

[728] *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2345. Insurance Equities Corporation, it will be recalled, held substantial blocks of the stocks of Lloyds Casualty Company and of Detroit Fidelity and Surety Company. See note 623, supra. Three of the five voting trustees of the stocks of Lloyds Casualty Company of New York and Detroit Fidelity and Surety Company were members of the Cohen group (op. cit. supra, note 568, at 1342–3).

[729] See notes 577 and 724, supra. In a letter (op. cit. supra, note 568, Exhibit No. 193–A) written to Mr. Barnes by Edward S. Goodwin, one of the founders of Insuranshares Corporation of Delaware, and a reputed authority in insurance company stocks (id., at 91), Mr. Goodwin stated:

> In the first place, you and your associates must know that the operating results of the Detroit Fidelity and Surety Company and the Lloyds Casualty Company during 1931 were very unfavorable, and a very large aggregate loss was sustained. The surplus accounts of both companies have been greatly depleted. Both are stocks which were eliminated from our [Insuranshares Corporation of Delaware] portfolio when the turn for the worse in their affairs became apparent. This was done some time ago, and since then matters have gone from bad to worse, and it is difficult to see how anyone could recommend these stocks at the present time as proper purchases for the portfolio of the investment company.

[730] Id., at 829.

[731] Id., at 832.

suffered a loss of $247,500, its entire investment in the stock of Lloyds Insurance Company of America.[732]

On July 3, 1932, the obligation of Insurance Equities Corporation to purchase 64,497 shares of the stock of Insuranshares Certificates, Inc. at $3.25 a share from the United Founders Corporation group, matured. On June 30, 1932, the Cohen controlled investment committee[733] of Insuranshares Corporation of Delaware agreed to purchase 64,497 shares of the stock of Insuranshares Certificates, Inc. from Insurance Equities Corporation at a price of $3.25 a share, although the market price of such stock was $1.50 a share.[734]

Early in July 1932, Insuranshares Corporation of Delaware tendered its own check to the United Founders Corporation group in payment for the 64,497 shares of the stock of Insuranshares Certificates, Inc. The United Founders Corporation group, on the advice of counsel,[735] refused to accept the check of Insuranshares Corporation of Delaware in a performance of the obligation of Insurance Equities Corporation. Thereafter, Insuranshares Corporation of Delaware paid to Insurance Equities Corporation $209,615.25 for the 64,497 shares of the stock of Insuranshares Certificates, Inc., and Insurance Equities Corporation by its own check paid this sum over to the United Founders Corporation group in satisfaction of its obligation to purchase such shares from the United Founders Corporation group.[736] As a result, Insuranshares Corporation of Delaware had acquired 64,497 shares of the stock of Insuranshares Certificates, Inc., at a cost of $209,615.25 when the market value of such stock was $96,745.40. In other words, Insuranshares Corporation of Delaware incurred an excessive cost of $112,869.85 as a result of the transaction. Furthermore, Insurance Equities Corporation, as will be described later, removed the shares of Insuranshares Certificates, Inc., from the portfolio of Insuranshares Corporation of Delaware by exchanging for such stock the common stock of Insuranshares Corporation of Delaware itself.

Meanwhile, on June 6, 1932, Edward B. Twombly and C. Parker Kuhn, two of the minority directors of Insuranshares Corporation of Delaware, met Mr. Seagrave, Mr. Devendorf, and Mr. Taylor of the United Founders Corporation group of companies in the office of Mr. Seagrave. At this meeting, Mr. Twombly charged that the United Founders Corporation group had been aware of the fact that Insurance Equities Corporation had sold its own stock to Insuranshares Corporation of Delaware in order to derive funds to make the down

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[732] At December 31, 1933, Insuranshares Corporation of Delaware valued its holdings of 18,000 shares of the stock of Lloyds Insurance Company of America at one dollar (*Moody's Manual of Investments, Banks, etc.*, 1935, p. 1597).

[733] Mr. Barnes testified that after the objection of the minority directors of Insuranshares Corporation of Delaware to the purchase of the stock of Constitution Indemnity Company, all transactions of Insuranshares Corporation of Delaware with Insurance Equities Corporation were approved by the investment committee of the company which reported them to the board of directors as "accomplished facts" (op. cit. supra, note 568, at 1670). Mr. Barnes also testified that meetings of the investment committee were so arranged that Hobart B. Brown, the minority member of the committee, "never quite got to the meetings until they were over" (id., at 1671). Mr. Twombly protested several times that control over the purchase of securities by Insuranshares Corporation of Delaware should remain in the company's board of directors and not in its investment committee (id., at 381).

[734] Id., at 896 and Commission's Exhibit No. 140.

[735] Id., at 1561.

[736] Id., at 892.

payment due the United Founders Corporation group of investment companies for control of Insuranshares Corporation of Delaware. Mr. Twombly testified: [737]

"The demand was made that United Founders refund the money and undo the transaction. We said we believed that the transaction was an improper transaction and could be upset by proper legal action and we threatened legal action at that time."

Mr. Twombly further testified [738] that in reply to his charge and his demand that the United Founders Corporation group "undo the transaction," the statement was made by Mr. Seagrave that "the [United Founders Corporation] companies had been without knowledge of the purposes of the new management in respect of this investment [by Insuranshares Corporation of Delaware in the stock of Insurance Equities Corporation], that they assumed no responsibility for it, the sale had been a bona fide one, and good afternoon gentlemen * * *." [739]

However, after this meeting Mr. Devendorf went to see Mr. Menken, who was counsel for Insurance Equities Corporation. Mr. Menken informed Mr. Devendorf that he thought the purchase by Insuranshares Corporation of Delaware of the stock of Insurance Equities Corporation was a legally sound transaction.[740] Mr. Seagrave later was informed that the Cohen group had consented to substitute other securities for the securities of Insurance Equities Corporation in the portfolio of Insuranshares Corporation of Delaware.

However, the officials of the United Founders Corporation group of investment companies never took any steps to ascertain whether or not the substitution had been made. Mr. Seagrave testified: [741]

Q. In July, August, September, October, November and December of 1932, did you find out whether or not that transaction [the purchase of the stock of Insurance Equities Corporation of Delaware] had been rescinded?

A. No, because every one of the men who complained remained on that board and throughout that period there was no further complaint.

Q. Did you find out whether or not the transaction had been rescinded?

A. No, I did not.

Q. Were you ever told that that transaction had ever been rescinded?

A. I don't believe I was told that it actually had been done.

At this time, June 1932, Insurance Equities Corporation had only paid $306,000 of its $550,004 obligation to the United Founders Corporation group, which had matured on May 31, 1932. Insurance Equities Corporation was also obligated to pay United Founders Corporation group on July 31, 1932, the final installment of $819,297 on the purchase price for control of Insuranshares Corporation of Delaware. In June 1932, Insurance Equities Corporation informed the United Founders Corporation group that it would not be able to meet the payment due them on July 31, 1932, and requested an extension of time to pay its total indebtedness.[742]

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[737] Id., at 313–4.

[738] Id., at 334.

[739] Mr. Seagrave testified that he told Mr. Twombly "to sue all he wanted to. I was very much annoyed and I said it very emphatically" (id., at 1398).

[740] Id., at 742, 1399.

[741] Id., at 1477–8.

[742] Id., at 1406–7.

In this situation, the United Founders Corporation group of investment companies, for the first time, demanded a financial statement of Insurance Equities Corporation, and on June 21, 1932, Insurance Equities Corporation submitted to the United Founders Corporation group an uncertified financial statement of its affairs as of May 31, 1932.[743] The United Founders Corporation group did not insist on a balance sheet of Insurance Equities Corporation certified by independent public accounts.[744] The uncertified statement set forth the assets of Insurance Equities Corporation as having a value of $6,341,000. However, this valuation represented the cost of the securities listed as owned by Insurance Equities Corporation.[745] Moreover, the securities listed, for the most part, represented securities which Insurance Equities Corporation had agreed to purchase but had not yet acquired.[746] The unpaid purchase prices which Insurance Equities Corporation was obligated to pay for such securities were carried as liabilities. The total liabilities of Insurance Equities Corporation were listed at $3,787,000. However, the securities listed by Insurance Equities Corporation as assets at a cost of $6,341,000 had an actual market value, in June 1932, of approximately $2,937,628,[747] so that, based on the market value of its assets, Insurance Equities Corporation with listed liabilities of $3,787,000 was then actually insolvent.[748]

Furthermore, Mr. Barnes testified that, during the course of his negotiations with Mr. Seagrave to obtain for Insurance Equities Corporation an extension of time for the payment of its indebtedness to the United Founders Corporation companies, he had informed Mr. Seagrave that it would be "suicidal" for Insurance Equities Corporation to dispose of its portfolio in the market to derive funds: [749]

Q. And isn't it correct, Mr. Barnes, that in these discussions that you had with Mr. Seagrave, you frankly expressed yourself and that he agreed with you that it would be suicidal, to use your phrase, to have Insurance Equities Corporation attempt to simply sell in the market such securities as it had?

A. In the manner you describe of telling a broker to sell it in the market, yes, it would have been suicidal.

Mr. Seagrave, himself, testified that during his discussions with Mr. Barnes, it became obvious to him that the Cohen group did not

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[743] Id., at 1450 and Exhibit M.

[744] Id., at 1466.

[745] Id., at 1446–7.

[746] For example, the 64,497 shares of the stock of Insuranshares Certificates, Inc., which Insurance Equities Corporation was obligated to purchase from the United Founders Corporation group on July 3, 1932, and which were later purchased by Insuranshares Corporation of Delaware from Insurance Equities Corporation (see supra), were carried on the balance sheet of Insurance Equities Corporation at cost. Similarly, 100,000 shares of Lloyds Casualty Company were carried as owned by Insurance Equities Corporation when it actually held only approximately 22,000 shares of the stock of Lloyds Casualty Company (ibid.).

[747] Op. cit. supra, note 568, Exhibit 192.

[748] Mr. Seagrave, however, contended that market values were not fair values in view of the then demoralized and depressed condition of securities markets (id., at 1449). Mr. Seagrave testified (id., at 1451):

> Q. With a company which was owing $1,500,000 to American Founders, didn't you concern yourself with what the realizable value of its securities was? Did you or didn't you?
> A. I did not attempt to find the market.

[749] Id., at 1690.

have the $5,000,000 of resources which they had represented they possessed.[750] However, Mr. Barnes informed Mr. Seagrave that Insurance Equities Corporation expected to raise money to meet its installment payments due the United Founders Corporation group by borrowing $800,000 after the formation of Lloyds Insurance Company of America as a consolidation of Constitution Indemnity Company, Lloyds Casualty Company, and Detroit Fidelity and Surety Company; by exchanging Insuranshares Corporation of Delaware stock for the stock of two California insurance companies and $400,000 in cash; and finally by exchanging Insuranshares Corporation of Delaware stock through Allied General Corporation for the certificates of beneficial interest in various fixed trusts. The fixed trust certificates were to be turned in for the underlying portfolio securities held by the various fixed trusts, and the sale of the portfolio securities, according to Mr. Barnes, would bring to Insurance Equities Corporation approximately $350,000.[751]

It will be recalled that the contract for the purchase of control of Insuranshares Corporation of Delaware by Insurance Equities Corporation provided that a majority of the board of directors of Insuranshares Corporation of Delaware was to be restored to the United Founders Corporation group of investment companies by Insurance Equities Corporation if it defaulted on any of its payments to the United Founders Corporation group. However, despite Mr. Twombly's charge that Insurance Equities Corporation had used the assets of Insuranshares Corporation of Delaware itself to make payments to the United Founders Corporation group, and Insurance Equities Corporation's acknowledgement in July 1932 of its inability to meet the installments due to the United Founders Corporation group on the purchase contract, the United Founders Corporation group did not exercise its privilege to be restored to control of Insuranshares Corporation of Delaware. Mr. Seagrave testified:[752]

Q. After these accusations of fraud that Mr. Twombly had made that the Insurance Equities people were acting improperly, after they had defaulted in their payments and after they had told you that they would have to have extensions of time and after you saw Exhibit M [the uncertified financial statement of Insurance Equities Corporation as at May 31, 1932] neither you nor anyone else of American Founders ever made any demand on Insurance Equities Corporation to restore to the control of the corporation [Insuranshares] until full payment had been made, the nominees of American Founders?

A. No, because I had been informed that these matters complained of on June 6th had been or were in the process of being corrected.

Instead, the United Founders Corporation group of investment companies granted to Insurance Equities Corporation an extension of time on the following terms: $63,000 was to be paid to the United Founders Corporation group on August 4, 1932; the balance of $1,000,000 then remaining due was to be paid in equal installments

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750 Mr. Seagrave testified (id., at 1481):

Q. * * * the obvious reason was that these people did not have it and could not pay; isn't that the fact?
A. They told me that.

751 Id., at 1405, 1412.

752 Id., at 1474.

of $250,000 on September 4, October 4, November 4, and December 4, 1932.[753]

On August 4, 1932, Insurance Equities Corporation paid $63,000 to the United Founders Corporation group and was thereby permitted to remain in control of Insuranshares Corporation of Delaware.[754] Thereafter, Insurance Equities Corporation continued to use the assets of Insuranshares Corporation of Delaware both as a source of funds to meet its installment obligations to the United Founders Corporation group of investment companies and for the consummation of Mr. Cohen's program for the consolidation of insurance companies.

After the passage of control of Insuranshares Corporation of Delaware to Insurance Equities Corporation, Frank Cohen and Albert Greenfield, a Philadelphia banker, agreed to contribute the funds necessary to purchase all of the assets of Inter-Southern Life Insurance Company which on April 16, 1932, had been taken over for liquidation by the Insurance Department of the State of Kentucky.[755] Among the principal assets of Inter-Southern Life Insurance Company were its holdings of 148,500 shares, or approximately 30%, of the stock of Missouri State Life Insurance Company.[756]

On July 19, 1932, Mr. Cohen and Mr. Greenfield organized the Kentucky Home Life Insurance Company with a capitalization of 50,000 shares of $10 par value stock.[757] Mr. Greenfield purchased 37,500 shares of the new company's stock at a price of $20 a share, or a total of $750,000, and on July 29, 1932, Insuranshares Corporation of Delaware purchased from the new company 12,500 shares of its stock at a total price of $275,000 which included a $25,000 "loading charge" paid to Insurance Equities Corporation.[758]

On August 4, 1932, the new company, Kentucky Home Life Insurance Company, purchased all the assets of Inter-Southern Life Insurance Company.[759]

The plan of the Cohen group was eventually to merge the Kentucky Home Life Insurance Company with the Jefferson Standard Life Insurance Company and to use Missouri State Life Insurance Company as the nucleus for a merger of various life insurance companies doing business in the Southwest.[760]

Subsequently, Insurance Equities Corporation, with $1,000,000 borrowed from The Continental Bank & Trust Company of New York,[761] purchased Mr. Greenfield's holdings of the stock of Kentucky Home Life Insurance Company.

Thus, the Cohen group through its controlled companies, Insurance Equities Corporation and Insuranshares Corporation of Delaware,

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753 Id., at 1406–7, 1640.

754 Ibid.

755 Id., at 1143 and *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2163.

756 *Moody's Manual of Investments, Banks, etc.*, 1933, pp. 2184 and 2700; and op. cit. supra, note 568, at 1143.

757 *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2700.

758 Op cit. supra, note 568, at 909–10, 1143.

759 *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2163.

760 Op. cit. supra, note 568, at 1148, 1150–1. As will be described later, Insuranshares Corporation of Delaware was caused by Insurance Equities Corporation to purchase 1,000 shares, or 10%, of the stock of Jefferson Standard Life Insurance Company.

761 Id., at 1160. The loan was secured by 26,000 shares or 57% of the stock of Kentucky Home Life Insurance Company, 28,000 shares of the stock of Insuranshares Corporation of Delaware, and "$500,000 worth" of the stock of Lloyds Casualty Company of New York (id., at 1152).

acquired substantially all of the stock of Kentucky Home Life Insurance Company,[762] and through their control of Kentucky Home Life Insurance Company [763] the Cohen group acquired a substantial influence in the management of Missouri State Life Insurance Company,[764] 30% of the stock of which was owned by Kentucky Home Life Insurance Company.

Without the expenditure of any of their own funds the Cohen group thus had acquired control or a substantial influence in the affairs of two life insurance companies which had combined assets of approximately $175,000,000 [765] and combined insurance written and in force of approximately $1,216,000,000.[766]

By December 1933, Insuranshares Corporation of Delaware had accumulated 17,160 shares [767] of the stock of Kentucky Home Life Insurance Company at a cost of $391,500.[768] In addition, by the same date Insuranshares Corporation of Delaware had acquired, at a cost of $143,799.88, a total of 15,770 shares of the stock of Missouri State Life Insurance Company,[769] a company in which, as has been indicated, Kentucky Home Life Insurance Company also had a substantial interest.

Meanwhile, in June 1933, the Cohen group had drawn a plan for the merger of Kentucky Home Life Insurance Company with Jefferson Standard Life Insurance Company [770] which, however, The Continental Bank & Trust Company of New York, which held 52% of the stock of Kentucky Home Life Insurance Company as collateral for a loan to Insurance Equities Corporation, refused to approve.[771]

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[762] Mr. Cohen testified that between them Insurance Equities Corporation and Insuranshares Corporation of Delaware held 49,955 shares of the stock of Kentucky Home Life Insurance Company (id., at 1144).

[763] Julius H. Barnes, Franklin Berwin, Carl Sherman, and Frank Cohen, all members of the Cohen group, became directors of Kentucky Home Life Insurance Company (*Moody's Manual of Investments, Banks, etc.*, 1933, p. 2700).

[764] Julius H. Barnes became chairman of the board of directors and a voting trustee of the stock of Missouri State Life Insurance Company (*Moody's Manual of Investments, Banks, etc.*, 1933, p. 2183–4).

[765] The total assets of Missouri State Life Insurance Company at the end of 1931 had a balance-sheet value of approximately $155,000,000 and the total assets of Kentucky Home Life Insurance Company were approximately $20,000,000 (*Moody's Manual of Investments, Banks, etc.*, 1933, pp. 2184, 2701).

[766] The Missouri State Life Insurance Company had at the end of 1931 total insurance written and in force of approximately $1,125,000,000 (id., at 2183). Kentucky Home Life Insurance Company had at the end of 1932 insurance written and in force of approximately $91,000,000, representing principally reinsurance of policies which had been issued by Inter-Southern Life Insurance Company (id., at 2700).

[767] As has been described, 12,500 shares of the stock were acquired from Kentucky Home Life Insurance Company itself. The remaining 4,660 shares of the stock were acquired from Insurance Equities Corporation and other controlled companies in 1933 in an exchange of securities. (See infra, pp. 1223–5.)

[768] Op. cit. supra, note 650, Commission's Exhibit No. 99; *Moody's Manual of Investments, Banks, etc.*, p. 1597; and derived from supplementary information supplied the Commission for Insuranshares Corporation of Delaware.

[769] Ibid.

[770] By this time Insuranshares Corporation of Delaware had been caused by Insurance Equities Corporation to purchase 10% of the stock of Jefferson Standard Life Insurance Company.

[771] Op. cit. supra, note 568, at 1150. In September 1933 The Continental Bank & Trust Company of New York, which had advanced $1,000,000 to Insurance Equities Corporation to enable it to secure control of Kentucky Home Life Insurance Company, on the failure of Insurance Equities Corporation to repay the loan, acquired the collateral for such loan, which included 52% of the stock of Kentucky Home Life Insurance Company, at a public

Thereafter, on August 28, 1933, Missouri State Life Insurance Company became insolvent and was taken over by the Insurance Department of the State of Missouri.[772] E. B. McHaney, who at the time was chief counsel for the Insurance Department of the State of Missouri, testified:[773]

A. The Superintendent as plaintiff instituted an action under the law of Missouri on the ground that the company [Missouri State Life Insurance Company] was insolvent * * *.

Q. Had the difficulty with the Missouri State Life been that in the past various individuals had obtained control of that company and had used the company for their own purposes?

A. That is true. The Missouri State Life had an unfortunate experience or experiences. Beginning in the '20's the stock of Missouri State Life had been sold repeatedly to various interests and as the result of those interests abusing the assets, the Missouri State Life combined with the financial depression at the time the suit was brought, the company was impaired to the extent of at least twenty-nine million dollars.

As a result of the insolvency of Missouri State Life Insurance Company, Insuranshares Corporation of Delaware's investment of $143,799.88 in the stock of Missouri State Life Insurance Company was appraised by directors of Insuranshares Corporation of Delaware at $23,655 at the end of 1933.[774] An unrealized loss of $120,846.88 had then been suffered by Insuranshares Corporation of Delaware on this investment.

The insolvency of Missouri State Life Insurance Company caused a sharp depreciation in the value of the holdings of Insuranshares Corporation of Delaware in the stock of Kentucky Home Life Insurance Company, which owned 30% of the stock of Missouri State Life Insurance Company. As at December 31, 1933, the 17,160 shares of Kentucky Home Life Insurance Company which had been acquired at a cost of $391,500 were valued by the directors of Insuranshares Corporation of Delaware at $171,600.[775] An unrealized loss of $219,900 had thus been suffered in this investment.

On September 4, 1932, Insurance Equities Corporation was obligated to pay $250,000 to the United Founders Corporation group. On August 30, 1932, Insurance Equities Corporation had a bank balance of only $1,000.[776] However, on that day Insurance Equities Corporation had agreed to purchase 6,500 shares, or 13%, of the capital stock of Shenandoah Life Insurance Company at a price of

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auction of such collateral (id., at 1160 and *Moody's Manual of Investments, Banks etc.*, 1935, p. 1597). Mr. Cohen testified that at this point the credit of Insurance Equities Corporation "went all to pieces." (Op. cit. supra, note 568, at 1169.) On February 13, 1934, Insurance Equities Corporation was placed in the hands of a receiver by the Chancery Court of Delaware (*Moody's Manual of Investments, Banks, etc.*, 1935, p. 1597).

[772] *Poor's Fiscal Volume*, 1934, p. 1784. On September 7, 1933, all of the assets and the policies of Missouri State Life Insurance Company were taken over by General American Life Insurance Company (ibid.), which had been formed and was controlled by The Equity Corporation, an investment company of the general-management type (Public Examination, The Equity Corporation, at 7987, et seq.)

[773] Id., at 7990–1.

[774] *Moody's Manual of Investments, Banks, etc.*, 1934, p. 2699.

[775] Ibid.

[776] Op. cit. supra, note 568, at 922.

$42 a share.[777] Insurance Equities Corporation was to pay $142,671 in cash for this stock and to deliver its note for $121,000 for the balance of the purchase price.[778] On the same day Insurance Equities Corporation sold these 6,500 shares of the stock of Shenandoah Life Insurance Company to Insuranshares Corporation of Delaware for a total price of $301,500,[779] or a per share price of $46. The highest market price of the stock of Shenandoah Life Insurance Company on the Richmond Stock Exchange during the year 1932 was $30 a share; the low was $15.[780] The payment of $301,500 made to Insurance Equities Corporation for this stock was therefore $104,000 in excess of its maximum market price for the year 1932.

Of the $301,500 so obtained by Insurance Equities Corporation, $142,671 was paid by it to the sellers of the stock of Shenandoah Life Insurance Company and $28,500 was paid as a commission to one David Baird.[781] The remaining $130,329, plus an additional $120,000 which Insurance Equities Corporation had borrowed, was paid over to the United Founders Corporation group on September 1, 1932.[782] In this manner, Insurance Equities Corporation met its installment payment of $250,000 due to the United Founders Corporation group on that date. To meet this payment Insurance Equities Corporation had used $130,000 of the assets of Insuranshares Corporation of Delaware. Furthermore, by the use of the funds of Insuranshares Corporation of Delaware and without the expenditure of their own funds, the Cohen group had acquired a position of influence in Shenandoah Life Insurance Company, which at the end of 1932 had total assets of approximately $7,000,000 and insurance written and in force of approximately $127,000,000.[783]

On October 4, 1932, another installment payment of $250,000 was due by Insurance Equities Corporation to the United Founders Corporation group. On that day Insurance Equities Corporation had available cash of only $3,000.[784] On that day, however, Insuranshares Corporation of Delaware paid over $250,000 to Insurance Equities Corporation against the future delivery of 16,363 shares of the stock of Philadelphia Life Insurance Company.[785] On the same day Insurance Equities Corporation paid to the United Founders Corpora-

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[777] Id., at 918 and Exhibit 162. The sellers were Shenandoah Holding Corporation and Foundation Finance Corporation, two Virginia corporations (ibid.).

[778] Id., at 1295. The note given by Insurance Equities Corporation to the sellers of the Shenandoah Life Insurance Company stock was never paid by Insurance Equities Corporation (ibid.).

[779] Id., at 918.

[780] *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2175.

[781] Op. cit. supra, note 568, at 918, and Commission's Exhibit No. 163.

[782] Id., at 918 and 923. The $120,000 of loans were obtained from The Continental Bank & Trust Company of New York and from William Morris and Co. of Philadelphia (id., at 923).

[783] Julius H. Barnes became chairman of the board of directors and Frank Cohen and Franklin Berwin, other members of the Cohen group, became directors of Shenandoah Life Insurance Company (*Moody's Manual of Investments, Banks, etc.*, 1933, p. 2175).

[784] Op. cit. supra, note 568, at 837.

[785] Id., at 839. The transaction was set up as a loan by Insuranshares Corporation of Delaware to Insurance Equities Corporation and, pending the delivery of the stock of Philadelphia Life Insurance Company, was secured by 40,000 shares of the common stock of Insuranshares Corporation of Delaware, which were released by the United Founders Corporation group to Insurance Equities Corporation on the payment of the $250,000 to the United Founders Corporation group on October 4, 1932 (id., at 841, 1060, 1416).

tion group of investment companies the $250,000 which it had obtained from Insuranshares Corporation of Delaware.[786]

In November 1932, Insurance Equities Corporation acquired 16,363 shares, or 23%,[787] of the stock of Philadelphia Life Insurance Company from various individuals in Philadelphia for a total price of $212,734,[788] or approximately $37,000 less than the price Insuranshares Corporation of Delaware had paid for the shares. Insurance Equities Corporation, however, paid only $51,734 in cash for the stock and delivered its note for $161,000, collateralized by 24,306 shares of the stock of Insuranshares Corporation of Delaware, to the sellers of the Philadelphia Life Insurance Company stock.[789] This note, however, was never paid by Insurance Equities Corporation.[790]

The 16,363 shares of the stock of Philadelphia Life Insurance Company were transferred by Insurance Equities Corporation to Insuranshares Corporation of Delaware in November 1932.[791] These 16,363 shares cost Insuranshares Corporation of Delaware $250,000, or an average price of $15. No quoted market price for the stock existed. However, it is significant that in December 1932, Insuranshares Corporation of Delaware purchased an additional 440 shares of such stock at a price of $5 a share.[792]

However, the Cohen group did not permit Insuranshares Corporation of Delaware to retain the Philadelphia Life Insurance Company stock. On February 21, 1933, Insurance Equities Corporation exchanged 18,000 shares of the stock of Insuranshares Corporation of Delaware for 8,500 shares of the stock of Philadelphia Life Insurance Company held by Insuranshares Corporation of Delaware. The total cost of the Philadelphia Life Insurance Company stock exchanged by Insuranshares Corporation of Delaware for its own stock was approximately $127,500.[793] The 18,000 shares of its own stock which Insuranshares Corporation of Delaware received in exchange had a then market value of $2.75 a share,[794] or a total market value of $49,500. In other words, the effect of the sale to Insuranshares Corporation of stock of Philadelphia Life Insurance Company and the subsequent exchange for its own stock was to cause Insuranshares Corporation of Delaware to purchase its own stock at a price $78,000 in excess of its market value.

On May 26, 1933, Insurance Equities Corporation exchanged 4,610 shares of the stock of Kentucky Home Life Insurance Company for the remaining shares of the stock of Philadelphia Life Insurance Company held by Insuranshares Corporation of Delaware.[795] A substantial loss was later incurred by Insuranshares Corporation of Delaware[796] on the Kentucky Home Life Insurance Company stock so acquired from Insurance Equities Corporation.

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[786] Id., at 839.

[787] At December 31, 1931, Philadelphia Life Insurance Company had outstanding 70,000 shares of capital stock (*Moody's Manual of Investments, Banks, etc.*, 1932, p. 2059).

[788] Op. cit. supra, note 568, at 843.

[789] Ibid.

[790] Id., at 844.

[791] Id., at 840.

[792] Id., at 849.

[793] Id., at 846–7.

[794] Id., at 867.

[795] Id., at 846–7.

[796] See supra.

On November 4, 1932, the installment payment of $250,000 due from Insurance Equities Corporation to the United Founders Corporation group was not paid, and on November 23, 1932, the United Founders Corporation group demanded final payment of the $500,000 still due them by Insurance Equities Corporation. However, on the agreement of Insurance Equities Corporation to pay $250,000 in December 1932, the United Founders Corporation group permitted the continuation of the control of Insurance Equities Corporation over Insuranshares Corporation of Delaware.[797] The United Founders Corporation group did not assert their contractual right to be restored to the management of Insuranshares Corporation of Delaware until they had been fully paid by Insurance Equities Corporation.

On December 17, 1932, Insurance Equities Corporation paid $250,000 to the United Founders Corporation group of investment companies. Although the record does not indicate the source from which Insurance Equities Corporation had derived these funds, on December 12, 1932, Insurance Equities Corporation had sold to Insuranshares Corporation of Delaware, 1,000 shares of the stock of Jefferson Standard Life Insurance Company at a profit of $45,000.[798]

Early in December 1932, Insurance Equities Corporation had agreed to purchase from Julian Price, the president of Jefferson Standard Life Insurance Company,[799] 51,000 shares or 51% of the stock of that company, at a price of $350 a share,[800] a sum $85 a share in excess of the liquidating value of the stock.[801] On December 12, 1932, Insuranshares Corporation of Delaware, through Insurance Equities Corporation, purchased 1,000 shares or 10% of the stock of Jefferson Standard Life Insurance Company for $350,000, plus a $45,000 "loading charge" to Insurance Equities Corporation, or a total price of $395,000.[802]

The Jefferson Standard Life Insurance Company stock which Insuranshares Corporation of Delaware had then acquired had no quoted market value,[803] and, as has been stated, had been acquired at a price approximately $85 a share in excess of the asset value of such stock. On December 31, 1933, after the termination of the control of Insuranshares Corporation of Delaware by Insurance Equities Corporation, the directors of Insuranshares Corporation of Delaware appraised the value of the 1,000 shares of Jefferson Standard Life Insurance Company stock held by Insuranshares Corporation of Delaware at $218,500.[804] Thus, by December 31, 1933 Insuranshares

[797] Op. cit. supra, note 568, at 1417–8.

[798] Id., at 947–9.

[799] Mr. Cohen described Jefferson Standard Life Insurance Company as a "very important company" in his plans. This company was to form the nucleus for a consolidation of various life insurance companies, including Shenandoah Life Insurance Company, Philadelphia Life Insurance Company (large blocks of which, as has been seen, were acquired by Insuranshares Corporation of Delaware), Kentucky Home Life Insurance Company, and Occidental Life Insurance Company, Raleigh, N. C. (id., at 1148).

[800] Id., at 945 and Commission's Exhibit No. 173. The 1,000 shares of the stock acquired by Insuranshares Corporation of Delaware were the only shares of the company's stock actually acquired by the Cohen group (id., at 945).

[801] Id., at 953–4.

[802] The actual expense (including commissions) of Insurance Equities Corporation in negotiating the purchase of this stock was $2,050 (id., at 949, 952–3).

[803] Id., at 953–4.

[804] *Moody's Manual of Investments, Banks, etc.*, 1934,, p. 2699.

Corporation of Delaware had suffered an unrealized loss of $176,500 on this investment.

The final installment of $250,000 due by Insurance Equities Corporation on December 4, 1932, was not paid on maturity nor was it ever fully paid by Insurance Equities Corporation. Nevertheless, the United Founders Corporation group of companies permitted Insurance Equities Corporation to remain in sole control of Insuranshares Corporation of Delaware.

On March 17, 1933, Insurance Equities Corporation, as a result of a series of transactions with Insuranshares Corporation of Delaware, was enabled to pay $75,000 of its final $250,000 installment payment to the United Founders Corporation group.

During February and up to March 7, 1933, Insuranshares Corporation of Delaware had purchased through Insurance Equities Corporation 43,135 shares of the stock of Penn General Casualty Company at a cost of $6.30 a share, or a total of $271,780.25, a price which included a $35,000 "loading charge," or commission retained by Insurance Equities Corporation.[805]

On March 10, 1933, a total of 32,000 shares of the stock of Penn General Casualty Company were transferred to Insurance Equities Corporation by Insuranshares Corporation of Delaware in exchange for 32 000 shares of its own stock. The 32,000 shares of its own stock which Insuranshares Corporation of Delaware thus acquired had a market value of $2.50 a share,[806] or a total market value of $80,000. On the other hand, the 32,000 shares of Penn General Casualty Company had cost Insuranshares Corporation of Delaware $6.30 a share, or a total of $201,600. The effect of the transaction, therefore, was to compel Insuranshares Corporation of Delaware to reacquire 32.000 shares of its own stock at a cost $121,600 in excess of its market value.

Insurance Equities Corporation immediately sold 25,000 shares of the 32.000 shares of the stock of Penn General Casualty Company which it had acquired in this exchange to C. B. Love, one of the original sellers of the stock,[807] to Insuranshares Corporation of Delaware for $143.000.[808] Mr. Love, however, paid only $23,372.87 to Insurance Equities Corporation itself. For the account of Insurance Equities Corporation, Mr. Love paid $75,000 to the United Founders Corporation group of investment companies which applied the payment against the $250,000 then due them by Insurance Equities Corporation. Mr. Love also paid $36.000 of the purchase price of the Penn General Casualty Company stock to Frank Cohen, and the balance of the purchase price was used to pay certain small obligations of Insurance Equities Corporation to brokers.[809]

As at December 31, 1933, Insuranshares Corporation of Delaware held 16,335 shares of the stock of Penn General Casualty Company,[810] or approximately 32% of the 50,000 outstanding shares of that com-

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[805] Op. cit. supra, note 568, at 930–1 and 937. The actual sellers of the Penn General Casualty Company stock were Edward J. Boughton of Philadelphia who sold 29,560 shares and C. B. Love who sold 13,575 shares (id., at 931).

[806] Id., at 935.

[807] See note 805, supra.

[808] Op. cit. supra, note 568, at 935–6.

[809] Ibid.

[810] *Moody's Manual of Investments, Banks, etc.*, 1935, p. 1597.

pany. The cost of these securities to Insuranshares Corporation of Delaware was $102,256.95.[811] In 1933 Penn General Casualty Company was restrained from doing business.[812] As at December 31, 1935, the board of directors of Insuranshares Corporation of Delaware appraised the company's holdings of the stock of Penn General Casualty Company at $30,920.[813] Thus an unrealized loss of $71,337 had been suffered on this stock by Insuranshares Corporation of Delaware.

As has been described, by March 1933, primarily by the use of the assets of Insuranshares Corporation of Delaware, the United Founders Corporation group of investment companies had received payment from Insurance Equities Corporation of all but $175,000 of the purchase price for control of Insuranshares Corporation of Delaware.

Although Insurance Equities Corporation had defaulted on its final installment payment to the United Founders Corporation group of investment companies, the United Founders Corporation group did not attempt to restore themselves to control of the management of Insuranshares Corporation of Delaware.

The Cohen group utilized their continued control of Insuranshares Corporation of Delaware to remove a large portion of the portfolio of Insuranshares Corporation of Delaware in exchange for stock of Insuranshares Corporation of Delaware itself and other securities, many of which later proved to be worthless.

From May 29 to October 30, 1933, Insuranshares Corporation of Delaware delivered securities and cash having a total value of $1,114,-987.49 to F. E. C., Inc., a corporation controlled by Frank Cohen,[814] in exchange for securities (principally its own stock) having a total market value at the time of the exchanges of $884,693.50. By these exchanges Insuranshares Corporation of Delaware therefore suffered a loss of $230,293.99.[815] Insuranshares Corporation of Delaware received in these exchanges 90,018 shares of its own stock;[816] 50 shares of the stock of Jefferson Standard Life Insurance Company; 290,638 shares of the stock of Insuranshares and General Management Company;[817] 4,660 shares of the stock of Kentucky Home Life Insurance Company; 2,200 shares of the stock of Penn General Casualty Company;[818] 702 shares of the stock of Missouri State Life Insurance Company;[819] and 32,709 shares of the stock of Brewery and Distilleries Securities Corporation. The cost of this latter block of stock to Insuranshares Corporation of Delaware was $156,045.[820] On Decem-

[811] Derived from supplementary information supplied the Commission for Insuranshares Corporation of Delaware.

[812] *Moody's Manual of Investments, Banks, etc.*, 1935, p. 1597.

[813] Op. cit. supra, note 811.

[814] Op. cit supra, note 568, at 1197–8.

[815] Id., at 955–7.

[816] Id., at 1717–8. These shares of its own stock were taken in by Insuranshares Corporation of Delaware at $7 a share, although the average market value of such stock from May to October was approximately $3 a share.

[817] This stock of Insuranshares & General Management Company had, at December 31, 1936, been written off the books of Insuranshares Corporation of Delaware as practically worthless (*Poor's Fiscal Volume*, 1938, p. 2873).

[818] This company, as has been stated, was restrained from doing business in 1933.

[819] This company, as has been described, became insolvent in 1933.

[820] Derived from supplementary information supplied the Commission for Insuranshares Corporation of Delaware.

ber 31, 1936, the directors of Insuranshares Corporation of Delaware valued the entire block at $1.[821]

In return for these securities Insuranshares Corporation of Delaware transferred to F. E. C., Inc., 157,514 shares of the stock of Insuranshares Certificates, Inc., 3,320 shares of the stock of Shenandoah Life Insurance Company, 8,303 shares of the stock of Philadelphia Life Insurance Company, and small blocks of the preferred and common stocks of Insurance Equities Corporation.[822]

As a result of this exchange with F. E. C., Inc., and previous exchanges of securities with Insurance Equities Corporation,[823] Insuranshares Corporation of Delaware had reacquired from these two sources a total of 140,018 shares of its own stock at a cost of approximately $550,000 in excess of the market value of such stock.[824]

As has been stated, Insurance Equities Corporation, largely because of its access to the funds of Insuranshares Corporation of Delaware, was able to complete all but $175,000 of its installment payments due the United Founders Corporation group. In August 1933, because of the failure of Insurance Equities Corporation to meet its final payment of $175,000, the United Founders Corporation group of investment companies sold its notes and the collateral consisting of the controlling block of stock of Insuranshares & General Management Company, which in turn held all of the Class B stock of Insuranshares Corporation of Delaware, to John H. Orgill, a Cleveland attorney, for $100,000.[825] Mr. Orgill then designated Harry M. Blair as his representative on the board of directors of Insuranshares Corporation of Delaware.[826]

By December 31, 1933, all of the representatives of Insurance Equities Corporation and Frank Cohen had resigned from the board of directors of Insuranshares Corporation of Delaware.[827] At that date, the total assets of Insuranshares Corporation of Delaware had a value of approximately $300,000,[828] as compared with the approximately $15,000,000 originally contributed by the public to Insuranshares Cor-

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[821] *Poor's Fiscal Volume,* 1938, p. 2873.

[822] Derived from supplementary information supplied the Commission for Insuranshares Corporation of Delaware.

[823] It will be recalled that Insurance Equities Corporation had transferred to Insuranshares Corporation of Delaware 32,000 shares of the stock of the latter corporation in exchange for 32,000 shares of the stock of Penn General Casualty Company and an additional 18,000 shares of the stock of Insuranshares Corporation of Delaware for 8,500 shares of the stock of Philadelphia Life Insurance Company. (See supra, pp. 1220–22.)

[824] The 90,018 shares acquired in the F. E. C., Inc., exchange were taken in by Insuranshares Corporation of Delaware at a price of $7, although the market value of the stock was $3 a share. As a result, the corporation acquired the 90,018 shares of its own stock at a price approximately $360,000 in excess of its market value. The total excess cost over the market value of the 50,000 shares of its own stock which Insuranshares Corporation had acquired from Insurance Equities Corporation in exchange for the stock of Penn General Casualty Company and Philadelphia Life Insurance Company was $199,600. (See supra, pp. 1220 and 1222.)

[825] Op. cit supra, note 568, at 1563.

[826] Public Examination, First Income Trading Corporation, et al., at 1051.

[827] Op. cit. supra, note 568, at 1034.

[828] Op. cit. supra, note 826, at 1063–4. Mr. Blair testified (ibid.):

> Q. Well, after they [the Cohen group] got through liquidating what was the value of the portfolio?
> A. I think we could have liquidated in October, November, December 1933, for about $250,000 to $300,000.
> Q. So that the portfolio which, if they had locked it up at that time, you said in October 1933, was only worth a quarter of a million dollars; is that so?
> A. Under the hammer, that is all we could have gotten for it.

poration of Delaware. In the period of approximately one year and a half during which Insurance Equities Corporation controlled Insuranshares Corporation of Delaware, the latter company was caused to liquidate its entire portfolio of well-known insurance company stocks at a realized loss on the basis of original cost of approximately $11,000,000; and these portfolio securities were replaced with non-dividend-paying stocks of the lesser known casualty and life insurance companies, several of which it will be recalled, had thereafter become insolvent.[829] Had the securities which were in the portfolio of Insuranshares Corporation of Delaware prior to the passage of its control to Insurance Equities Corporation been kept intact, the portfolio would have had a value of about $7,000,000 at the end of 1936.[830]

Early in 1937, Insuranshares Corporation of Delaware received from the United Founders Corporation group approximately $320,000[831] in settlement of a suit brought against the United Founders Corporation group to recover the amount paid by Insurance Equities Corporation to the United Founders Corporation group on the contract to purchase control of Insuranshares Corporation of Delaware, which payments were made with the cash realized by Insurance Equities Corporation in self-dealing transactions with Insuranshares Corporation of Delaware.[832]

i. Insuranshares Corporation of Delaware—Northern Fiscal Corporation

By December 1937 Insuranshares Corporation of Delaware had total assets of approximately $800,000 and had outstanding 284,032 shares of its common stock.[833] The original purchasers of these shares had contributed approximately $13,878,933 net to Insuranshares Corporation of Delaware, so that as at December 31, 1937, the stockholders[834] had experienced a loss, realized and unrealized, of approximately $13,000,000 on their investment.[835]

Of 284,032 shares of the common stock of Insuranshares Corporation of Delaware outstanding on December 31, 1937, an aggregate of approximately 80,000 was held by Mr. Blair, who was president and a director of the company, by The Continental Bank & Trust Company

[829] Op. cit. supra, note 826 at 1059, 1062–3, and Commission's Exhibit No. 99.

[830] Id., at 1063.

[831] Id., at 1069.

[832] The suit was settled by the payment of $750,000 by American General Corporation (successor by consolidation of the United Founders Corporation group of companies), and of this amount approximately $320,000 was received by Insuranshares Corporation of Delaware, $239,000 by counsel (39 Col. L. Rev. 814 (1939)), and the remainder by creditors of Insurance Equities Corporation.

[833] Id., at 1070 and Commission's Exhibits Nos. 53 and 64. By this time Insuranshares & General Management Company had been liquidated and its holdings of all of the Class B stock of Insuranshares Corporation of Delaware had been acquired and retired by Insuranshares Corporation of Delaware (*Moody's Manual of Investments, Banks, etc.*, 1938, p. 1525; and Public Examination, First Income Trading Corporation, et al., at 1510).

[834] As at December 18, 1937, there were 4,658 shareholders of Insuranshares Corporation of Delaware (Public Examination, First Income Trading Corporation, et al., Commission's Exhibit No. 53, p. 3).

[835] Public Examination, First Income Trading Corporation, et al., Commission's Exhibit No. 64. The total capital raised by the company was $15,893,750, but the company, to December 31, 1937, had returned to its stockholders by way of dividends and repurchases of its shares $2,014,817 (ibid.).

of New York and by three Philadelphia banks.[836] Mr. Blair had acquired 4,000 shares of the common stock of Insuranshares Corporation of Delaware in the open market at a cost of $3,200, and, in addition, he and C. J. Simmons, another director and the counsel for Insuranshares Corporation of Delaware, were jointly obligated to purchase an additional 10,000 shares of this common stock from a certain bank at a cost of $20,000.[837] Thus, Mr. Blair, in effect, was the owner of 14,000 shares of the common stock of Insuranshares Corporation of Delaware which had cost him $23,200.

In December 1937, S. Leo Solomont, Ralph H. Robb, and Thomas W. Morris began to acquire control of investment companies.[838] They first directed their attention to the acquisition of control of Insuranshares Corporation of Delaware. Mr. Blair testified that, although he did not desire another "Frank Cohen pulled" on him,[839] he was particularly impressed with Mr. Robb:[840]

Q. What did he say that impressed you?

A. Oh, the general thing. You know, you judge a man by his appearance, and so forth.

Q. What?

A. First by his appearance, by the way he comports himself. I had quite a conversation with him. I happened to know some people in Boston that he knew and we exchanged notes. I was really impressed. He was the one man that I got best acquainted with.

On December 15, 1937, Mr. Blair agreed to sell his holdings and to cause the other large stockholders of Insuranshares Corporation of Delaware—The Continental Bank & Trust Company of New York and other banks located in Philadelphia—to sell their holdings of the common stock of Insuranshares Corporation of Delaware to Thomas W. Morris. Mr. Morris agreed to purchase an aggregate of 78,260 shares of the common stock of Insuranshares Corporation of Delaware at a price of $3.60 a share and also agreed to pay to Mr. Blair a commission of $10,091 for his services in "arranging that sale * * * to me of this stock."[841] Both Mr. Morris and the sellers of the stock were aware that the then liquidating value of the stock to be sold was $2.87 a share,[842] so that Mr. Blair and the other large selling stockholders of Insuranshares Corporation of Delaware were conscious of the fact that Mr. Morris was willing to pay a total premium above the asset value of their shares of approximately $78,000.

That Mr. Morris was paying this price solely to obtain control is evident from the fact that although the total number of shares he had agreed to purchase constituted only approximately 28% of the outstanding stock of Insuranshares Corporation of Delaware, he in-

[836] Id., at 1106–7, and Commission's Exhibit No. 53.

[837] Id., at 1071–3.

[838] For a detailed discussion of the activities of these individuals in the acquisition of control of investment companies, see supra, pp. 1075–8, and Ch. II of this part of the report, pp. 437 et seq.

[839] Public Examination, First Income Trading Corporation, et al., at 1105–6.

[840] Id., at 1094–5.

[841] Id., Commission's Exhibit No. 53.

[842] Ibid.

sisted upon the resignation of all the existing directors and officers of the company and upon their replacement by his own nominees. Mr. Blair and the other stockholders selling their shares acceded to this demand.[843] Mr. Blair also agreed that the 21,500 shares of New England Fund held by Insuranshares Corporation of Delaware would be converted into cash prior to the closing date of the contract.[844] The fact that Mr. Morris agreed to pay this substantial premium on a minority block of the company's stock, his evident insistence upon obtaining control of the management of the company, and his demand that the New England Fund stock be converted into cash prior to the date of the closing, might have suggested that Mr. Morris may have intended to recoup his investment in the company in a manner detrimental to the interest of the company's stockholders. Yet Mr. Blair took no steps to protect the minority stockholders of Insuranshares Corporation of Delaware, who, it will be recalled, had already suffered tremendous losses as a result of a prior change in the management of their company. Mr. Blair, when examined on that aspect, testified:[845]

Q. Did you ask these people whether they would make the same offer to other stockholders so that they could get the same price and get out?

A. No; I didn't.

Q. Did you ask for any representation on the Board of Directors, the new Board?

A. No; I didn't want it.

Q. Did you get any agreement in writing that they were not going to change the nature of the portfolio?

A. No.

The closing date for the contract was set for December 21, 1937.[846] Prior thereto Paine, Webber & Co. had agreed to advance to Mr. Solomont $310,000.[847] Of this amount, $270,000 was to constitute an advance cash payment on 21,500 shares of beneficial interest in New England Fund, which were owned by Insuranshares Corporation of Delaware.[848] Paine, Webber & Co. were informed that these shares

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[843] Ibid.

[844] This conversion into cash did not take place. However, on December 16, 1937, five days before the closing of the contract for the sale of control of Insuranshares Corporation of Delaware, the board of directors of that corporation, all of whom were either the owners or represented the owners of the stock which was to be sold to the Northern Fiscal group (Messrs. Solomont, Robb, Morris, and their associates), "authorized the New England Fund to transfer certificates of beneficial interest of said New England Fund standing in the name of Insuranshares Corporation of Delaware and aggregating 21,500 shares to S. Leo Solomont," and "further that they shall not be placed in the name of S. Leo Solomont until he is duly elected and qualified as treasurer" of Insuranshares Corporation of Delaware (id., Commission's Exhibit No. 52). As will be seen, infra, the New England Fund shares were used by the Northern Fiscal group to derive the major part of the funds necessary to purchase control of Insuranshares Corporation of Delaware.

[845] Id., at 1113–4.

[846] Id., Commission's Exhibit No. 53.

[847] Id., at 350–1.

[848] Id., at 351–3. Mr. Paine testified that he could not consider the investment in New England Fund as collateral for a loan since it was not a listed security. He suggested to Mr. Solomont that the board of directors of Insuranshares Corporation of Delaware authorize the liquidation of this stock. The transfer of the shares in New England Fund to Paine, Webber & Co., therefore, constituted merely a transfer for the purposes of their sale on behalf of Insuranshares Corporation of Delaware (id., at 352). In order to have these shares in proper negotiable form, the board of directors representing the old management, on December 16, 1937, provided that the 21,500 shares of beneficial interest in New England Fund be

were to be liquidated for the account of Insuranshares Corporation of Delaware and the proceeds were to be invested in "a Canadian investment company."[849] The balance of $40,000, to the knowledge of Paine, Webber & Co., was to constitute a loan to be secured by "other securities" of Insuranshares Corporation of Delaware as collateral.[850]

On December 21, 1937, checks of Paine, Webber & Co. totaling $310,000 were made payable to Mr. Blair and the other sellers of the stock of Insuranshares Corporation of Delaware.[851] Immediately upon the payment for this stock, the representatives of the old management resigned, in accordance with the terms of the contract of sale, and the nominees of Messrs. Solomont, Robb, and Morris (the Northern Fiscal group) were placed on the board.[852] The new board of directors of Insuranshares Corporation of Delaware immediately caused that investment company to purchase 5,000 shares of preferred stock of Northern Fiscal Corporation, Ltd., the personal company of Messrs. Solomont, Robb, and Morris at $100 a share for a total of $500,000 from Arthur Quint, a representative of S. Leo Solomont.[853] Portfolio securities of Insuranshares Corporation, valued at $500,000, including the New England Fund shares, were turned over to Mr. Quint, as consideration for the 5,000 shares of preferred stock of Northern Fiscal Corporation, Ltd.,[854] sold to Insuranshares Corporation of Delaware.

Mr. Quint immediately assigned these portfolio securities to Mr. Solomont and Mr. Robb with the direction that they liquidate these securities, retain $310,000, which constituted the amount of the advance made by Paine, Webber & Co., and return the balance to Northern Fiscal Corporation, Ltd.[855] These portfolio securities were removed on December 21, 1937, from the vault of Insuranshares Corporation of Delaware and were transferred to Paine, Webber & Co. for the account of Insuranshares Corporation of Delaware in the name of Mr. Solomont and Mr. Robb.[856]

Paine, Webber & Co. liquidated these securities, deducted its $310,000 advance, and transmitted a balance of $152,321.40 to North-

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placed in the name of S. Leo Solomont as soon as he was elected and qualified as treasurer of Insuranshares Corporation of Delaware (id., at 1109–11).

[849] Id., at 1701–2.

[850] Id., at 351–3. These "other securities" were already in marketable form (id., at 1111). The contract had permitted the new management, between December 15 and December 21, 1937, to check the portfolio securities of the investment company, and provided that these securities be in bearer form (id., Commission's Exhibit No. 53).

[851] Id., Commission's Exhibits Nos. 49 and 53.

[852] The new officers and directors were Ralph H. Robb, S. Leo Solomont, Harold J. Tracy, D. C. Morgan, Thomas F. Stanton, Thomas W. Morris, and Arthur Quint. Mr. Robb was elected president of the company, and Mr. Solomont was elected treasurer (id., Commission's Exhibit No. 52).

[853] Mr. Solomont and his associates had organized Northern Fiscal Corporation, Ltd., in Canada on December 14, 1937, as a personal holding company, of which S. Leo Solomont was president, Ralph H. Robb was vice president, and Thomas W. Morris was treasurer. 10,000 shares of common stock were authorized, of which 9,997 shares were issued to Priscilla French, who was an employee of Mr. Morris and Mr. Robb, in consideration for 3,000 shares of Amm Gold Mines, Ltd., 6,000 shares of Cook Lake Gold Mines, Ltd., and $1,000 in cash (id., Commission's Exhibit No. 54). The remaining three shares of common stock were issued to Messrs. Solomont, Robb, and Morris.

[854] Id., Commission's Exhibit No. 48.

[855] Ibid.

[856] Id., Commission's Exhibits Nos. 48, 50.

ern Fiscal Corporation, Ltd.[857] In addition to this $152,321.40, the 78,260 shares of Insuranshares Corporation of Delaware common stock were also transferred to Northern Fiscal Corporation, Ltd., by Messrs. Robb, Morris, and Solomont as consideration for the sale of 5,000 shares of its own preferred stock to Insuranshares Corporation of Delaware.[858]

To sum up the transaction, portfolio securities of Insuranshares Corporation of Delaware, valued at $500,000, were liquidated, and $310,000 of the proceeds were used by the Northern Fiscal group to acquire control of Insuranshares Corporation of Delaware. In place of these liquid portfolio securities, valued at $500,000, thus removed by the Northern Fiscal group, Insuranshares Corporation of Delaware held 5,000 shares of the preferred stock of Northern Fiscal Corporation, Ltd. This preferred stock of Northern Fiscal Corporation, Ltd., held by Insuranshares Corporation of Delaware represented an interest in a corporation which held, in turn, 78,260 shares or 28% of Insuranshares Corporation of Delaware common stock, $152,321 in cash, and various Canadian mining stocks of uncertain value. At the conclusion of these transactions, the portfolio of Insuranshares Corporation of Delaware consisted only of its holdings of the preferred stock of Northern Fiscal Corporation, Ltd., which had no market, and certain other unmarketable blocks of securities of insurance companies and other companies which had been acquired by Insuranshares Corporation of Delaware from Insurance Equities Corporation during the period of the latter's control and management of Insuranshares Corporation of Delaware.

Thus, within a space of five years, from 1932 to 1937, the stockholders of Insuranshares Corporation of Delaware suffered a loss of practically their entire investment in the company as the result of the transfer of its control to Insurance Equities Corporation and thereafter to Northern Fiscal Corporation, Ltd. In each case the new controlling interests paid for their control by the use of the

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[857] Francis X. Mancuso, a former judge of the Court of General Sessions of the County of New York, and Lorimer A. Davidson received $15,000 as "commissions" for effecting this transaction (id., Commission's Exhibit No. 89). Upon the consummation of the transaction Mr. Mancuso and Mr. Davidson received $7,500 in cash (id., at 791). Two days after the closing of the contract on December 23, 1937, Mr. Mancuso and Mr. Davidson received the balance in the form of a telegraphic postal money order (id., at 792). Mr. Mancuso denied that there was anything unusual in this practice. He testified (id., at 792):

Q. Let me understand, when you say cash, do you mean dollars?
A. Currency, actual cash. There were one-hundred-dollar bills—no; there were several five-hundred-dollar bills and one-hundred-dollar bills.
Q. And the second seventy-five hundred dollars you got in a money order; is that it?
A. Western Union Telegraph Company.
Q. Didn't it seem strange to you, Judge, that you were being paid in cash and not by check; did you give these people a receipt for this seventy-five hundred dollars?
A. I think we did. There was nothing strange. As a matter of fact, I understand that is the usual way brokers in those deals are paid, in cash.
Q. By hundred-dollar bills?
A. Five-hundred and one-hundred bills.

However, when Mr. Mancuso received a commission from the same individuals for a subsequent transaction involving the acquisition of control of another investment company, he was paid in check. This change in procedure did not, however, arouse Mr. Mancuso's suspicions.

[858] Id., Commission's Exhibit No. 54. In addition, Northern Fiscal Corporation, Ltd., received an assignment of an oil and gas lease consisting of about 127 acres on the G. Anderson survey in Texas. (Ibid.)

investment company's own assets. Mr. Blair, when examined on that phase of the company's history, testified:[859]

Q. And do the things that have transpired in the last couple of months kind of remind you of the things that transpired in that corporation in 1932?

A. The only difference is in the size.

Q. And the difference in the name, isn't that so?

A. Yes.

Q. Instead of Northern Fiscal Corporation, Ltd., that you have now, all you have to do is substitute the name Insurance Equities Corporation and you have precisely the same picture in 1932.

A. And other subordinate corporations that followed that.

* * * * * * *

Q. The Northern Fiscal Corporation sold Insuranshares Corporation of Delaware only $500,000 of its own stock, and in 1932 Insurance Equities Corporation sold Insuranshares Corporation of Delaware $600,000 of its own stock.

A. $650,000.

* * * * * * *

Q. They made a loan to make the initial down payment on the contract, and then they went in and sold Insurance Equities Corporation stock to Insuranshares Corporation of Delaware and paid off the loan with the bank, isn't that so?

A. They took out of the portfolio of Insuranshares Corporation of Delaware—they took out enough good securities to turn it over to the bank and gave them carte blanche to sell them and pay them.

Q. In the case of the sale of control of Insuranshares Corporation of Delaware in 1938 there was an assignment to Robb, Morris, Solomont to sell enough securities to pay the $300,000?

A. Yes.

* * * * * * *

Q. And you know that Insurance Equities Corporation which sold the insurance stocks to Insuranshares Corporation of Delaware, that Insurance Equities Corporation was Cohen & Barnes, isn't that so?

A. Practically.

Q. Now, that Insurance Equities Corporation corresponds to the Northern Fiscal Corporation, Ltd., which was the holding company that they organized specifically for the transaction, isn't that so?

A. I think it was.

On June 15, 1938, Insuranshares Corporation of Delaware was placed in receivership.[860]

j. Ungerleider Financial Corporation—Atlas Corporation

Ungerleider Financial Corporation was incorporated in Delaware on May 7, 1929, with an authorized capitalization of 3,000,000 shares of stock, all of one class and without par value. The corporation had general power to buy, sell, and deal in securities and to engage in the underwriting and distribution of securities.[861] The corporation

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[859] Id., at 1053–4, 1058–9, 1064.

[860] On June 15, 1938, a custodial receiver was appointed on the petition of a stockholder to protect the company's assets against further depletion by the Northern Fiscal group (*The New York Times,* June 16, 1938, p. 33).

[861] Public Examination, Ungerleider Financial Corporation, Commission's Exhibit No. 1528.

was created at the instance of Samuel Ungerleider & Company, members of the New York Stock Exchange and investment bankers.[862]

On May 8, 1929, the corporation entered into a contract with Samuel Ungerleider & Company whereby Samuel Ungerleider & Company was to manage the corporation's affairs until December 31, 1939, for an annual fee of 20% of the corporation's net profits, provided that after deduction of this fee the remaining profits for the year were equivalent to at least 8% of the corporation's invested capital. The agreement, however, could be terminated at any time upon the vote of a majority of the corporation's stockholders.[863] Since the corporation's profits at no time exceeded 8% of its invested capital, no management fees were ever paid to Samuel Ungerleider & Company.[864] During the period of the management of the corporation by Samuel Ungerleider & Company, all of the brokerage business of the corporation accrued to that firm.[865]

On May 18, 1929, Samuel Ungerleider & Company entered into an agreement with the corporation to purchase 500,000 shares of its stock at a price of $50 a share to net the corporation a total of $25,000,000.[866]

The prospectus offering these shares stated that Samuel Ungerleider & Company were purchasing 50,000 shares of the corporation's stock, creating the fair implication that the firm was purchasing the stock for permanent investment.[867] Actually, the firm only purchased 20,000 shares of the corporation's stock for its own account.[868]

Eventually the corporation disposed of 244,400 shares of its stock for which it received a total consideration of $13,205,575.76.[869]

As at April 30, 1931, the date that control of Ungerleider Financial Corporation was acquired by Atlas Corporation, the net assets of the corporation totaled $10,192,643.69,[870] as compared with its net contributed capital of $13,205,575.76. Losses realized and unrealized incurred by the corporation during its management by Samuel Ungerleider & Company totaled, therefore, $3,012,932.07.

In large part these losses were due to unsuccessful underwritings and to defaults on loans secured by non-liquid collateral. A number of these transactions will be described in another chapter of the Commission's over-all report.[871]

Loans made by the corporation and secured by unmarketable collateral totaled approximately $1,600,000 by the close of 1929, and constituted more than 10% of the Ungerleider Financial Corporation's net contributed capital of $13,205,575.[872] The prospectus used in selling its stocks did not reveal any intention upon the part of the corporation to act as a lending institution.[873] Eventually a realized

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[862] Id., at 14879.

[863] Id., Commission's Exhibit No. 1546.

[864] Id., Commission's Exhibit No. 1554.

[865] Id., Commission's Exhibit No. 1546.

[866] Id., Commission's Exhibit No. 1530.

[867] Id., Commission's Exhibit No. 1532.

[868] Id., at 14986.

[869] Id., at 14910.

[870] Public Examination, Atlas Corporation, Commission's Exhibits Nos. 2003 and 2043.

[871] For discussion of these loans, see Chapter VII of this part of the report, which relates to the management of assets of investment companies.

[872] Op. cit. supra, note 861, at 14953.

[873] Id., Commission's Exhibit No. 1532.

loss of approximately $700,000 was suffered on these loans.[874] In addition, by July 1931, when Atlas Corporation took over the management of the corporation, it had suffered an unrealized loss on an underwriting of the securities of Bonwit Teller, Inc., of approximately $700,000.[875]

As early as April 9, 1930, the lack of success of Ungerleider Financial Corporation led to requests by stockholders of the company that it be dissolved.[876] Samuel Ungerleider & Company, however, refused to assent to a dissolution of the company, first, because it would have reflected upon the prestige and reputation of the firm and, second, because it was felt that the downward trend in the market for securities might cease in the near future.[877]

In addition, in October 1930, the New York Stock Exchange requested that, for the protection of its brokerage clients, the firm of Samuel Ungerleider & Company attain a more liquid asset position.[878] In order to accomplish this, it was necessary for the firm to dispose of some of its securities. On October 31, 1930, Louis R. Lurie, a wealthy San Francisco real-estate operator, whom Mr. Ungerleider described as a "friend"[879] of his firm, was induced to purchase the 20,000 shares of the stock of Ungerleider Financial Corporation owned by Samuel Ungerleider & Company. Mr. Lurie purchased this stock at a price of $25 a share, the then market price of the stock.[880] Though there was no understanding that Mr. Lurie would retain these shares, Mr. Ungerleider was under the impression that it was not the intention of Mr. Lurie to dispose of the shares.[881] Mr. Lurie subsequently became a special partner in the firm of Samuel Ungerleider & Company[882] and commenced to increase his holdings of Ungerleider Financial Corporation shares. By February 1931 Mr. Lurie had, apparently by purchases in the market, increased his holdings of the stock of Ungerleider Financial Corporation to 70,000 shares.[883]

Meanwhile, L. Boyd Hatch, a director and vice president of Atlas Corporation, had approached Mr. Ungerleider several times to discuss the possible acquisition of control of Ungerleider Financial Corporation by Atlas Corporation.[884] In December 1930, Father Joseph Conner, a priest who was a mutual friend of both Mr. Odlum and Mr. Ungerleider, arranged for a meeting among Mr. Lurie, Mr. Ungerleider, and Mr. Odlum.[885] The meeting, however, did not re-

[874] This loss was incurred as follows: $95,288 on a loan to Adrian Renz (id., at 14950); $366,975.50 on a loan to Magowan, Cassidy & White (id., at 14964); and $236,283 on a loan to Martin T. Manton, formerly a judge of the United States Circuit Court of Appeals for the Second Circuit (id., at 14941–2). These loans will be described in detail in Chapter VII of this part of the report, which relates to the management of the assets of investment companies.

[875] Id., at 14993.

[876] Id., Commission's Exhibit No. 1552.

[877] Id., at 15003.

[878] Id., at 15001.

[879] Ibid.

[880] Id., at 15006.

[881] Id., at 15006–7.

[882] Id., at 15012–13.

[883] Id., Commission's Exhibit No. 1553.

[884] Id., at 15007.

[885] Id., at 15007–8. Father Conner subsequently received $30,000 in "finder's fees," of which $15,000 was paid by Atlas Corporation (op. cit. supra, note 870, Commission's Exhibit No. 2001, p. 128) and $15,000 was paid by Mr. Lurie. (Derived from supplementary information supplied the Commission for Ungerleider Financial Corporation.)

sult in any definitive arrangement. Both Mr. Ungerleider and Mr. Lurie agreed to submit financial statements of the condition of Ungerleider Financial Corporation to Mr. Odlum for his consideration at a subsequent meeting between the parties.[886]

However, before the date of meeting arranged by the parties, Mr. Lurie, apparently without the knowledge of Mr. Ungerleider, met with Mr. Odlum, who was under the impression that Mr. Lurie represented Mr. Ungerleider as well as himself.[887] As a result of this meeting an agreement was reached on February 6, 1931, between Mr. Odlum and Mr. Lurie.[888] This agreement provided for the sale to Atlas Corporation by Mr. Lurie of his 70,000 shares of Ungerleider Financial Corporation at a price of $40 per share. The asset value of the stock at the time was approximately $40.95 per share, but its market value was approximately $24 per share. In fact the market price for the stock during the entire year of 1931 ranged from a high of $29½ to a low of $20.[889]

Mr. Lurie also agreed: [890] that (a) upon the request of Samuel Ungerleider or upon the request of Atlas Corporation he would "cause the name of Ungerleider Financial Corporation to be changed in accordance with such request"; and (b) he would "cause Samuel Ungerleider to assist and advise [Atlas Corporation] at all times in the liquidation of assets of Ungerleider Financial Corporation which are frozen or not readily liquid." The contract with Mr. Lurie further provided that Mr. Lurie would "cooperate with [Atlas Corporation] and cause Samuel Ungerleider to cooperate with [Atlas Corporation] in purchasing for [its] account shares of the capital stock of Ungerleider Financial Corporation, and [would] refrain and will cause Samuel Ungerleider to refrain from competing in any fashion whatsoever in the purchase of said shares." [891]

Although Atlas Corporation itself was the nominal contracting party with Mr. Lurie, it purchased only 2,500 of the 70,000 shares of Ungerleider Financial Corporation stock acquired from Mr. Lurie. Atlas Utilities & Investors Company, Ltd., the Canadian subsidiary of Atlas Corporation, purchased 10,000 of the shares. However, 57,500 of the 70,000 shares were purchased by Allied Atlas Corporation (originally known as Exide Securities Corporation), which was then 90% owned by Atlas Corporation. Allied Atlas Corporation paid $2,300,000 for the shares, purchasing them at $40 a share.[892] As has been stated, the market price of the shares was $24 a share, so that Allied Atlas Corporation paid a total of $920,000 in excess of the market price of the stock. The $2,300,000 expended by Allied Atlas Corporation constituted in excess of 33⅓% of its total assets.[893] As at December 31, 1930, the public held 29,901 shares or approximately 10% of the outstanding stock of Allied Atlas Corporation.[894]

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[886] Op. cit. supra, note 861, at 15008.
[887] Id., at 15007–8.
[888] Id., Commission's Exhibit No. 1553.
[889] Op. cit, supra, note 870, Commission's Exhibit No. 2001 (p. 126).
[890] Op. cit. supra, note 861, Commission's Exhibit No. 1553.
[891] Ibid.
[892] Op. cit. supra, note 870, Commission's Exhibit No. 2001 (p. 126).
[893] Reply to the Commission's questionnaire for Allied Atlas Corporation, Pt. I.
[894] Op. cit. supra, note 870, Id., Commission's Exhibit No. 2001 (p. 39).

Although Mr. Ungerleider testified that he had not authorized Mr. Lurie to represent him in these negotiations with Mr. Odlum,[895] Mr. Ungerleider remained a director and president of Ungerleider Financial Corporation until April 4, 1933,[896] and assisted Atlas Corporation in its attempts to salvage the illiquid loans of Ungerleider Financial Corporation, as well as aiding Atlas Corporation in its attempts to rehabilitate Bonwit Teller, Inc.[897] Samuel Ungerleider & Company and Fenner, Beane & Ungerleider, a stock exchange firm with which Mr. Ungerleider became associated in November 1931 and with which he remained until 1933, received a substantial amount of brokerage business from Atlas Corporation.[898] In addition, Samuel Ungerleider & Company acted as Atlas Corporation's brokers in the purchase of additional shares of Ungerleider Financial Corporation.[899] On February 25, 1931, Mr. Ungerleider introduced David Bernstein, a director of Ungerleider Financial Corporation and the holder of 30,000 shares of its stock, to L. Boyd Hatch of Atlas Corporation.[900] Mr. Bernstein had become aware of Mr. Lurie's sale to Atlas Corporation and apparently desired a similar price for his shares. As a result of this introduction, Atlas Corporation agreed to purchase Mr. Bernstein's stock at a price of $38 a share, a price approximately $2 less than the asset value of the stock but $11.62 a share in excess of the market value of the stock which was then selling at $27⅜ a share.[901]

These 30,000 shares of stock were not, however, acquired by Atlas Corporation itself. They were purchased by All America General Corporation, which was then approximately 60% owned by Atlas Corporation.[902] All America General Corporation's payment of $1,140,000 for the shares was approximately $318,750 in excess of the market value of the stock,[903] so that the 40% public interest in All America General Corporation[904] suffered an immediate loss on the purchase of approximately $127,500. The purchase price of $1,140,000 paid by All America General Corporation constituted in excess of 50% of its total assets.[905]

As a result of these two transactions, Atlas Corporation, through its controlled companies, acquired control of 100,000 shares of the stock of Ungerleider Financial Corporation, or approximately 41% of the 244,320 shares of the company then outstanding.[906] On March 31, 1931, L. Boyd Hatch, a director of Atlas Corporation, was elected a director of Ungerleider Financial Corporation.[907] By September 17, 1931, in addition to Mr. Hatch, Floyd B. Odlum, Oswald Johnston,

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[895] Op. cit. supra, note 861, at 15012.

[896] Id., Commission's Exhibit No. 1557.

[897] Derived from supplementary information supplied the Commission for Ungerleider Financial Corporation.

[898] Ibid.

[899] Op. cit. supra, note 870, Commission's Exhibit No. 2001, p. 128.

[900] Op. cit. supra, note 861, at 15012.

[901] Derived from supplementary information supplied the Commission for Ungerleider Financial Corporation and op. cit. supra, note 870, Commission's Exhibit No. 2001 (p. 126).

[902] Op. cit. supra, note 870, Commission's Exhibit No. 2001 (p. 22).

[903] Ibid.

[904] Ibid.

[905] Reply to the Commission's questionnaire for All America General Corporation, Pt. I.

[906] Op. cit. supra, note 870, Commission's Exhibit No. 2001 (p. 127).

[907] Op. cit. supra, note 861, Commission's Exhibit No. 1557.

Walter Petersen, and John W. Donaldson, all directors or officers of Atlas Corporation, had been elected to the board of directors of Ungerleider Financial Corporation.[908]

Minority stockholders were not formally informed of the shift in control of their corporation to Atlas Corporation until June 4, 1932, when they received an exchange offer of the shares of Atlas Corporation for their shares.

During the year 1931, Atlas Corporation purchased in the open market, largely through Samuel Ungerleider & Company as brokers, a total of 42,405 shares of the capital stock of Ungerleider Financial Corporation at a total cost of $1,262,405.25.[909] However, by December 31, 1931, Atlas Corporation had transferred to its then subsidiaries a total of 40,580 of these shares.[910] All sales were made on the basis of market values.[911]

These sales illustrate the technique by which Atlas Corporation caused its controlled investment companies to acquire control of other investment companies.

As at December 31, 1931, Atlas Corporation and its subsidiaries held 200,384 shares of Ungerleider Financial Corporation stock out of 244,320 shares outstanding. In other words, Atlas Corporation through its subsidiaries held 82% of the outstanding stock of Ungerleider Financial Corporation. Atlas Corporation itself held 3,525 shares. Its controlled companies owned the balance of the shares held within the Atlas Corporation group. All America General Corporation held 60,000; Allied Atlas Corporation, to which on May 29, 1931, Atlas Corporation had sold its controlling interest in All America General Corporation held 60,000 shares; and Securities Allied Corporation, which on August 17, 1931, had acquired control of Allied Atlas Corporation and, therefore, controlled All America General Corporation, held 76,859 shares.[912]

On June 4, 1932, Atlas Corporation addressed a letter to the minority stockholders of Ungerleider Financial Corporation offering to exchange three and one-half shares of its common stock for each share of the capital stock of Ungerleider Financial Corporation. The letter revealed the asset value of each Ungerleider Financial Corporation share to be $28.75.[913]

The letter did not reveal that the then asset value of the Atlas Corporation common shares was $2.97 a share, or a total asset value of

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[908] Ibid.

[909] Op. cit. supra, note 870, Commission's Exhibit No. 2001 (p. 127).

[910] Ibid.

[911] Ibid. The sales were as follows:

Date 1931	Number of shares	To whom sold	Cost to Atlas Corporation	Selling price	Profit or (loss)
Apr. 30	10,000	All America General Corporation	$310,000.00	$310,000.00	
June 4	9,635	Iroquois Share Corporation	298,532.00	269,780.00	($28,752.00)
Sept. 12	1,325	Securities Allied Corporation	36,711.50	36,711.50	
Sept. 19	2,120	Securities Allied Corporation	66,883.00	66,883.00	
Oct. 24	17,500	Securities Allied Corporation	529,060.10	607,425.00	78,364.90
Total	40,580		1,241,186.60	1,290,799.50	49,612.90

[912] Id., Commission's Exhibit No. 2001 (pp. 24, 108, and 129).

[913] Id., Commission's Exhibit No. 1970.

$10.39 for the three and one-half shares offered for each Ungerleider Financial Corporation share. However, the offering letter did state that the asset value of Atlas Corporation's common stock would be $7.30 a share if all of the stockholders of its 12 subsidiary investment companies accepted the exchange offers of Atlas Corporation which were being made simultaneously with the exchange offer for the stock of Ungerleider Financial Corporation. On the basis of an asset value of $2,97 for Atlas Corporation's common stock, acceptance of the Atlas Corporation offer involved a gross loss in assets of $18.36 a share to stockholders of Ungerleider Financial Corporation. On the basis of the hypothetical asset value of $7.30 a share of Atlas Corporation common stock, acceptance of the Atlas Corporation offer involved a loss in assets of $3.20 a share to stockholders of Ungerleider Financial Corporation. On the basis of market values the offer would result in a gain of 50 cents per share for each Ungerleider Financial Corporation shareholder.[914]

On September 23, 1932, Atlas Corporation, which then owned 91% of the stock of Ungerleider Financial Corporation renewed its above offer and as an alternative offered to exchange four-fifths of a share of its preference stock for each share of Ungerleider Financial Corporation stock. As a result of these offers, Atlas Corporation acquired 27,639 shares of Ungerleider Financial Corporation stock in exchange for 2,577 shares of its preference stock and 84,585½ shares of its common stock. On the basis of the June 4, 1932, asset value of $2,97 for each share of Atlas Corporation common stock, the loss to Ungerleider Financial Corporation stockholders who accepted the offer, resulting from the disparity in asset values of the securities exchanged, was $414,552.[915]

On November 4, 1933, the date on which Atlas Corporation caused Ungerleider Financial Corporation to be dissolved, Atlas Corporation and its subsidiaries held 215,025 shares of its stock, or 97.35% of the 220,755 shares of the corporation's stock then outstanding. The holdings of Atlas Corporation and its subsidiaries had been acquired at a book cost of $7,753,429.87. On the dissolution of Ungerleider Financial Corporation, Atlas Corporation, and its subsidiaries received a total in cash and in securities taken at their market values, of $6,342,646.40. Upon the basis of the market values of the securities received as a liquidating dividend by Atlas Corporation and its controlled companies, the Atlas Corporation group of companies suffered a loss of $1,410,783.47 on its investment in the stock of Ungerleider Financial Corporation.[916]

In determining the cash distributive shares due to stockholders of Ungerleider Financial Corporation, market prices of the securities in its portfolio were used as the basis of valuation. However, the portfolio of Ungerleider Financial Corporation which was distributed to Atlas Corporation and its subsidiaries and to minority stockholders who exercised an option to receive their distributive share of the corporate assets in portfolio securities included securities of several Atlas

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[914] Ibid. and id., Commission's Exhibit No. 2001 (p. 131).

[915] Id., Commission's Exhibit No. 2001 (p. 130). However, by becoming stockholders of Atlas Corporation, exchanging Ungerleider Financial Corporation stockholders to some extent retrieved their loss in asset values.

[916] Id., Commission's Exhibit No. 2001 (pp. 130–1 and 133–8).

Corporation controlled investment companies which at market prices were valued at $3,620,801.25. As at December 31, 1933, these securities had an asset value of $6,492,258.83. On the basis of the asset values of these securities, Atlas Corporation and its subsidiaries received a total of $9,214,103.98 as their distributive shares of the assets of Ungerleider Financial Corporation. On this basis of calculation, Atlas Corporation and its controlled companies derived a profit of $1,460,673.71 on their investment in the stock of Ungerleider Financial Corporation. In addition, the trustees in liquidation of Ungerleider Financial Corporation, as at June 30, 1936, still retained assets consisting primarily of the stock of Bonwit Teller, Inc., totaling $521,398.69. The proportionate interest of Atlas Corporation in these assets was $507,580.62.[917]

2. PURCHASE OF MANAGEMENT WARRANTS

a. To Induce Transfer of Control

(1) THE INVESTMENT COMPANY OF AMERICA—JONATHAN B. LOVELACE AND ASSOCIATES

The Investment Company of America was organized as a common-law business trust in Michigan on March 27, 1926, under the sponsorship of E. E. MacCrone & Company, a Detroit investment banking firm, which had membership in the New York Stock Exchange.[918] The trust indenture creating the company vested the sole power of management and control in the trustees and permitted the trustees to deal with the trust as principals.[919] However, the indenture provided for the creation of an advisory board which, by the vote of three-quarters of its members, was given the power to veto any proposed transaction between the trust and its trustees.[920] An advisory board of 10 prominent businessmen[921] was subsequently selected by E. E. MacCrone & Company,[922] and their names and corporate affiliations were prominently featured in the prospectuses used to sell the securities of The Investment Company of America to the public.[923]

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917 Id., Commission's Exhibit No. 2001 (p. 139).

918 Public Examination, American Capital Corporation, at 6994–5, 7001, and Commission's Exhibit No. 667.

919 Id., Commission's Exhibit No. 667. The trust indenture provided: "The shareholders shall have no right to exercise any control over the Investment Fund nor to participate in the management of the trust" (ibid.).

920 Ibid. The sole additional power of the advisory board was to approve or disapprove investments suggested by the trustees for inclusion in the "eligible list" of securities from which the trustees were to select investments for the trust (ibid.).

921 The initial members of the advisory board were: Standish Backus, president of the Burroughs Adding Machine Company; Leo M. Butzel, a director of the First National Bank in Detroit; Roy D. Chapin, chairman of the board of directors of Hudson Motor Company; Stanford T. Crapo, secretary-treasurer of Huron Portland Cement Company and a director of the Pere Marquette Railway Company; E. E. MacCrone, of E. E. MacCrone & Company; James S. Holden, chairman of the board of directors of The Security Trust Company of Detroit; E. D. Stair, president of the Detroit Free Press; Charles S. Mott, vice president of General Motors Corporation; Thomas H. White, vice president and general manager of White Motor Company; and E. A. Pierce, of E. A. Pierce & Company, members of the New York Stock Exchange (id., Commission's Exhibits Nos. 669 and 670). Subsequently, Mr. Pierce was replaced by Arthur H. Buhl (id., Commission's Exhibit No. 682).

922 Id., at 7034–7.

923 Id., Commission's Exhibits Nos. 669 and 670. Apparently many stockholders of The Investment Company of America were under the impression that the advisory board was responsible for the actual management of The Investment Company of America. In a letter written by the advisory board to the stockholders with reference to the transaction

Edward E. MacCrone, Jonathan B. Lovelace, and Charles J. Collins, all of whom were partners in E. E. MacCrone & Company, became three of the five trustees of The Investment Company of America.[924] In addition, E. E. MacCrone & Company, on March 21, 1927, obtained an exclusive fiscal agency contract to distribute the securities of The Investment Company of America for a period of 10 years[925] and in June 1927, through Investment Research Corporation, which was 80% owned[926] by E. E. MacCrone & Company, obtained a contract to furnish investment advice to The Investment Company of America on a cost basis.[927]

Between 1927 and 1930 the public purchased $5,000,000 face amount of debentures; 60,000 shares of 7% $100 par value preferred stock and 137,827 shares of common stock of The Investment Company of America for $14,581,658, of which $550,000 was retained as gross commissions by E. E. MacCrone & Company and $200,000 was retained by Bonbright & Company, Inc., which had offered to the public the $5,000,000 of debentures of The Investment Company of America.[928] The net proceeds derived by The Investment Company of America from the sale of these various securities amounted to $13,831,658.[929]

In addition to the underwriting commissions which it received, E. E. MacCrone & Company also received from The Investment Company of America option warrants to purchase within a period of 10 years a total of 210,000 shares of the common stock of The Investment Company of America at prices of $24 to $37.50 a share.[930] These warrants, Mr. MacCrone testified, were issued to his firm as compensation for its services in organizing The Investment Company of America and as permanent compensation for the firm's management of the investment company.[931] Of these warrants, approximately 58,000 were distributed by E. E. MacCrone & Company to members of the advisory board of

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by which control of The Investment Company of America was transferred from E. E. MacCrone & Company to J. B. Lovelace (see infra), the advisory board stated (id., Commission's Exhibit No. 683):

> Many of the letters [received by the advisory board from shareholders with reference to the proposed transfer of control] are written as if the writer were under the impression that the members of the Advisory Board had been managing The Investment Company of America or were charged with some specific duty in the conduct of its affairs and were in some way responsible for the present condition of the company or its affairs. The Advisory Board has not only no such duty but no such power.

[924] Id., at 7000 and 7025–6. The two remaining trustees were Raymond K. Dykema, counsel for E. E. MacCrone & Company (ibid.), and Albert J. Hettinger, Jr., the head of the investment research department of E. E. MacCrone & Company (id., at 7119) and the president of Investment Research Corporation, a company formed by E. E. MacCrone & Company to supply investment advice to various investment companies, including The Investment Company of America (id., at 7028 and Commission's Exhibit No. 670).

[925] Reply to the Commission's questionnaire for The Investment Company of America, Pt. I (Exhibit 6).

[926] Op. cit. supra, note 918, at 7275; but see id., Commission's Exhibit No. 682, which states that E. E. MacCrone & Company had a 90% ownership of Investment Research Corporation.

[927] Id., at 7040 and the reply to the Commission's questionnaire for The Investment Company of America, Pt. I (Exhibit 11). The contract could be terminated by either party on six months' notice.

[928] Id., at 7016, 7023–4, and Commission's Exhibit No. 671, and derived from supplementary information supplied the Commission for The Investment Company of America.

[929] Op. cit. supra, note 925, Pt. IV (Item 21).

[930] Op. cit. supra, note 918, at 7016–7, 7022, 7039, and op. cit. supra, note 925, Pt. VII (Item 76).

[931] Op. cit. supra, note 918, at 7018.

The Investment Company of America and to Albert J. Hettinger, Jr., and Raymond Dykema, two of the trustees of The Investment Company of America.[932]

From the inception of The Investment Company of America until June 1932, E. E. MacCrone & Company received all of the investment company's brokerage business, which Mr. MacCrone characterized as "profitable" to the firm of E. E. MacCrone & Company.[933]

By June 1932 the net assets of The Investment Company of America had declined to approximately $4,575,000,[934] as against the approximately $13,830,000 which the corporation had received from the sale of its securities.[935]

As the assets of the company declined in value, a sharp dispute arose among the trustees and members of the advisory board as to the investment policy to be pursued.[936] The immediate problem which generated this dispute was the fact that the debentures of The Investment Company of America contained a provision to the effect that a default would occur on such debentures if at any time the total resources of the company were less than 125% of the face amount of the outstanding debentures.[937] In June 1932 The Investment Company of America had outstanding $3,353,000 principal amount of debentures and total assets of approximately $4,375,000,[938] the equivalent of about 136% of the face amount of the company's outstanding debentures. In other words, a comparatively small further decline in the company's assets would have resulted in a default on the company's outstanding debentures.

Mr. Dykema and Mr. Hettinger, two of the trustees, were of the opinion that the investment company should repurchase its debentures which were then selling at a 40% discount from their face value, in order to increase the asset coverage of the remaining debentures and to free the corporate funds for investment in an effort to enhance the asset value of the holdings of the company's preferred and common

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[932] Id., at 7039. The nine members of the advisory board other than Mr. MacCrone received an average of 5,300 warrants; Mr. Hettinger received 6,100 warrants; and Mr. Dykema received 5,000 warrants (ibid., and the reply to the Commission's questionnaire for The Investment Company of America, Pt. VIII [Item 76]).

[933] Op. cit. supra, note 918, at 7267. Mr. MacCrone testified (ibid.):

> Q. Now, in addition to your investments in the stock of The Investment Company of America and in the warrants, your firm had the brokerage of the trust?
> A. It had the brokerage of the trust.
> Q. That was a valuable source of business?
> A. I think it proved profitable.

[934] Id., Commission's Exhibit No. 683.

[935] However, to December 31, 1931, the company had paid out in the form of interest and dividends a total of approximately $2,600,000 and had expended approximately $1,300,000 in the repurchase of $1,508,500 principal amount of its debentures and 2,742 shares of its preferred stock (Reply to Commission's questionnaire for The Investment Company of America, Pt. II [Schedules 16–5, 18–5, 20–1–6, and 20–A]). If the total of $3,900,000 expended for these purposes be deemed a partial return to the security holders of their investment in the company, the net capital contributed to the company to the end of 1931 was approximately $10,000,000. By June 1932, therefore, The Investment Company of America had suffered a shrinkage in the value of its assets approximately equal to 50% of its net contributed capital.

[936] Op. cit. supra, note 918, at 7150–4, 7240–1.

[937] Id., at 7151. Mr. Hettinger, one of the trustees of The Investment Company of America, testified:

> You can put the thing this way: The debentures required 125% coverage. That was your touch-off point. There is no question but that investment policy was hampered tremendously by that. I would say that in those stages internal fiscal policy was a matter of at least large moment in the picture as a whole (ibid.).

[938] Id., Commission's Exhibit No. 683.

stockholders.[939] The advisory board (particularly James S. Holden), the members of which with their families held a total of 5,473 shares of the preferred stock and 8,143 shares of the common stock of The Investment Company of America, were in accord with Mr. Dykema and Mr. Hettinger as to the investment policy to be pursued by the company.[940]

On the other hand, Mr. MacCrone and Mr. Collins, both of whom were partners in E. E. MacCrone & Company and trustees of The Investment Company of America, "urged that we liquidate that fund [The Investment Company of America] to cash and sit there until we were convinced that the tide had definitely turned."[941]

By 1932 the fifth trustee of The Investment Company of America, Mr. Lovelace, who had severed his connection with E. E. MacCrone & Company at the end of 1929[942] to become associated with American Capital Corporation and Pacific Southern Investors, Inc.,[943] two California investment companies, had become very inactive in the affairs of The Investment Company of America.[944]

As has been described, the four active trustees of The Investment Company of America were deadlocked on the question of the investment policy to be adopted by the company.[945] In addition, the advisory board, led by Mr. Holden, who Mr. MacCrone felt was the dominant personality on the advisory board, had become "antagonistic" to Mr. MacCrone.[946]

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[939] Id., at 7152–5. Mr. Hettinger testified:

> I was not worried about the bondholder because Bonbright, when they drew that indenture, drew a good clean type of indenture and the bondholder had nothing to worry about. But I wanted to be sure that the junior shareholders had their chance to come back (id., at 7156).

In June 1932 the net assets of The Investment Company of America were approximately $4,575,000. After deducting the $3,353,000 face amount of debentures outstanding, the assets available for the 57,000 outstanding shares of preferred stock and 137,627 shares of common stock totaled approximately $1,200,000 (id., Commission's Exhibit No. 683). In this situation the 57,000 shares of preferred stock, which had a liquidating preference of $5,700,000, had an actual asset value of approximately $21 a share and the common stock had a negative asset value. The preferred and common stocks had been sold to the public in 1927 and 1928 by E. E. MacCrone & Company in units of one share each at a price of $116.50 a unit (id., at 7015–6 and Commission's Exhibit No. 669).

[940] Id., at 7240–4, 7279, and Commission's Exhibit No. 683.

[941] Id., at 7240. Mr. Hettinger testified (id., at 7154):

> Q. What was your recollection of what Mr. MacCrone and Mr. Collins wanted to do at that time? You say they were opposed to further repurchases?
> A. As I recall it, they were opposed to further repurchases [of debentures] and wanted to keep quite liquid representing thereby the only basis for retaining insured solvency of the fund.

[942] Id., at 7320.

[943] Mr. Lovelace had been associated in the formation of American Capital Corporation in May 1928 (id., at 7094), and had purchased 30,000 shares of the Class B stock of American Capital Corporation at $2 a share (id., at 7105, 7323). In November 1931 Mr. Lovelace had taken an active part in the management of American Capital Corporation and of Pacific Southern Investors, Inc., which in 1932 was 40% controlled by American Capital Corporation (id., at 7381). Mr. Lovelace had become a director and chairman of the investment committees of both American Capital Corporation and Pacific Southern Investors, Inc. (id., Commission's Exhibit No. 683).

[944] Id., at 7368.

[945] As at June 17, 1932, the company had in fact repurchased $1,647,000 face amount of its debentures (id., Commission's Exhibit No. 683). On the other hand, on the same date $4,434,000 of the company's total assets of approximately $4,575,000 consisted of cash, United States Treasury Certificates, and short term corporate notes (ibid.).

[946] Id., at 7238, 7242–3, 7299.

To some extent this "antagonism" to Mr. MacCrone may have been the result of the fact that in 1932 E. E. MacCrone & Company had begun to negotiate for the sale of its fiscal agency contract with The Investment Company of America, its remaining 116,286 warrants to purchase stock of that company and its interest in Investment Research Corporation, which supplied research services to The Investment Company of America.[947] At this time, E. E. MacCrone & Company was indebted to Detroit banks to the extent of $1,000,000 secured by all the securities owned by E. E. MacCrone & Company, including the 116,287 warrants to purchase common stock of The Investment Company of America.[948] In 1932 the banks began to press for protection of the firm's loans.[949] In order to derive funds to meet the banks' demands, Mr. MacCrone entered into negotiations with others to sell his interests in The Investment Company of America.[950] Mr. MacCrone from time to time negotiated with a Chicago group of bankers who desired to purchase the E. E. MacCrone & Company warrants and other interests in The Investment Company of America for $1,000,000 [951] in order to invest the company's funds in commercial paper, and with the New York Stock Exchange firm of E. A. Pierce & Company which proposed to purchase the same assets of E. E. MacCrone & Company for $750,000 and to invest an additional $1,000,000 in the stock of The Investment Company of America.[952] That these offers were attractive is evident from the fact that the warrants held by E. E. MacCrone & Company to purchase 116,287 shares of the common stock of The Investment Company of America were exercisable at prices varying from $24 to $37.50 a share and at this time (early in 1932) the common stock of The Investment Company of America had no asset value.[953] In other words, the warrants had no immediate value.[954] The chief value of the fiscal agency contract with The Investment Company of America held by E. E. MacCrone & Company lay in the fact that under its terms the sale of any further original issues of securities by The Investment Company of America would require the issuance of additional warrants to the holder of

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[947] Id., Commission's Exhibit No. 682. These warrants were the remainder of 210,000 warrants which E. E. MacCrone & Company had acquired in 1928 as part compensation for their organization and sale of the securities of The Investment Company of America. (See supra, pp. 1238–9.)

[948] Op. cit. supra, note 918, at 7254–6. In addition, E. E. MacCrone & Company held 2,000 shares of the common stock of The Investment Company of America and a 22% interest in American Industries Corporation, which held 10,000 shares of the common stock of The Investment Company of America (id., at 7298).

[949] Id., at 7256. Mr. MacCrone testified:

> * * * [the banks] came to me and said, "Well, we feel that you should take steps to sell these assets and protect those loans" (ibid.).

[950] Id., at 7262–3. Mr. MacCrone testified:

> * * * it was not until it became obviously impossible for me to influence as I thought properly should be influenced, the policy, and obtain protection for the fund and my own personal loans got to a point where it was necessary to realize something by the sale of my assets, that I entered in actively or considered the sale of these interests at all (ibid.).

[951] Id., at 7257.

[952] Id., at 7259–61.

[953] See note 939, supra.

[954] The advisory board, which also held warrants to purchase stock of The Investment Company of America, which had been given to them by E. E. MacCrone & Company in 1928 (see note 932, supra), were of the opinion that their warrants as well as those held by E. E. MacCrone & Company were in 1932 not of "any present value" (op. cit. supra, note 918, Commission's Exhibit No. 683).

the contract.[955] The stock of Investment Research Corporation had little value since, according to the testimony of Mr. Lovelace, the corporation had a liability on a lease which exceeded its assets.[956]

However, the advisory board, led by Mr. Holden, refused to consent to the sale of E. E. MacCrone & Company's contracts and warrants to outside interests,[957] apparently because it was the "considered opinion" of the advisory board "that if any interest purchased The Investment Company of America that they would expect to get the value out of the investment in some way."[958] Moreover, the advisory board opposed the plan of the Chicago group, with whom Mr. MacCrone was negotiating to invest the assets of The Investment Company of America in commercial paper, on the ground "that there would be very small opportunity for recovery for the common stockholders."[959] In the face of this opposition upon the part of the advisory board, Mr. MacCrone abandoned the attempt of E. E. MacCrone & Company to dispose of its interests in The Investment Company of America to outsiders.[960]

Meanwhile, the deadlock of the trustees as to the investment policy to be adopted by The Investment Company of America continued. The attempts by E. E. MacCrone & Company to sell its various interests in The Investment Company of America apparently heightened the disagreement among the trustees and increased the advisory board's "antagonism" to Mr. MacCrone by creating the impression that E. E. MacCrone & Company were opposed to any shrinkage in the assets of The Investment Company of America which would result from the repurchase of its debentures, solely because of its desire to obtain an attractive price from others for its interests in The Investment Company of America. Mr. Hettinger testified:[961]

Q. Had you heard of any other reason for wanting to keep liquid? Was there any talk of selling out to other interests?

A. Yes.

Q. What talk was there?

A. That was a time when distress situations were being purchased by companies * * * and the larger the fund that they could purchase, the greater the price they would pay for it. I think it would be obvious that a five million fund presumably would command something more than a three-

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[955] Reply to the Commission's questionnaire for The Investment Company of America, Pt. I (Exhibit 6).

[956] Op. cit. supra, note 918, at 7379.

[957] Mr. MacCrone testified (id., at 7296–7):

> The matter was taken up with the Advisory Board through Mr. Butzel, and I addressed a letter to him outlining the plan completely, and it was discussed to the trustees, and I received no consideration for the plan whatsoever, and I discussed it with my friends, and they said that in view of the fact that the Advisory Board would give it no consideration, as they indicated they would not do, that to try to obtain consideration for it I would have to go to the courts, and that it would conceivably—if court action ensued—the court might say that by reason of the course of events that the trust should be dissolved, and all interests would be harmed by such a course. * * * I felt that I could get no place at all with the opposition of the Advisory Board.

[958] Id., at 7372–5.

[959] Id., at 7378.

[960] See note 957, supra. Mr. MacCrone was of the opinion that the advisory board resented the fact that the outside individuals who were negotiating for the purchase of E. E. MacCrone & Company's interests in The Investment Company of America intended to eliminate the advisory board and to retain Mr. MacCrone as a trustee (op. cit. supra, note 918, at 7258, 7261, 7299).

[961] Id., at 7154–5.

million fund. And Mr. MacCrone, I believe, was interested in negotiations at various times for the transfer of his interests.

In order to resolve the deadlock between the trustees, the advisory board had before it the possibility of a resort to the courts to obtain a judicial opinion as to the course to be pursued by the trust. Apparently the advisory board was of the belief that a court might order a dissolution of The Investment Company of America, which would wipe out substantially the entire investment of the preferred and common stockholders of the company.[962] It will be recalled that the members of the advisory board and their families held a large amount of the preferred and common stock of The Investment Company of America. In their dilemma, Mr. Dykema and Mr. Hettinger and the advisory board communicated early in 1932 with Mr. Lovelace, the fifth trustee of The Investment Company of America,[963] who presented a plan to the advisory board for the elimination of Mr. MacCrone and Mr. Collins as trustees of The Investment Company of America. Mr. Lovelace and certain associates [964] who owned 140,000 shares of the Class B stock of American Capital Corporation, a stock then having no asset value [965] and a market value of $1.50 a share,[966] proposed to transfer such stock to E. E. MacCrone & Company in return for that firm's fiscal agency contract with The Investment Company of America, the firm's holdings of 116,287 warrants to purchase common stock in The Investment Company of America, and the firm's 80% interest in Investment Research Corporation.[967] In addition, as further consideration, Mr. MacCrone and Mr. Collins were to resign as trustees of The Investment Company of America. Mr. Lovelace was to remain as a trustee and Reno Renfrew, one of his associates, would also be elected a trustee.[968] By these transactions Mr. Lovelace and Mr. Renfrew would acquire a position of substantial influence in the management of The Investment Company of America.

However, Mr. MacCrone was, as has been stated, in need of cash to meet his firm's bank loans. Accordingly, in order to procure Mr. MacCrone's assent to his plan, Mr. Lovelace proposed that The Investment Company of America purchase from E. E. MacCrone & Company at a price of $300,000, or $4 a share, 75,000 shares of the 140,000 shares of the Class B stock of American Capital Corporation which

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[962] Id., Commission's Exhibits Nos. 682 and 683. It will be recalled that in June 1932 the preferred stock of The Investment Company of America which had a liquidating preference of $100 a share had an actual asset value of approximately $21 a share and the common stock had a negative asset value. See note 939, supra.

[963] Op. cit. supra, note 918, at 7156 and 7369–71.

[964] These associates, and the number of shares of the Class B stock of American Capital Corporation which they owned, were as follows:

J. B. Lovelace	30, 950
R. B. Renfrew	11, 750
George J. Snook	36, 900
N. S. Dennis	23, 700
A California bank	27, 300
Others	9, 400

(Id., at 7375; and derived from supplementary information supplied the Commission for The Investment Company of America.)

[965] Op. cit. supra, note 918, Commission's Exhibit No. 682.

[966] Reply to the Commission's questionnaire for The Investment Company of America, Pt. VII (Item 70).

[967] Op. cit. supra, note 918, Commission's Exhibits Nos. 682, 683.

[968] Id., Commission's Exhibit No. 682.

that firm was to acquire from Mr. Lovelace and his associates.[969] In other words, Mr. Lovelace's proposal essentially was that The Investment Company of America itself was to pay E. E. MacCrone & Company $300,000 for the relinquishment of that firm's various interests in The Investment Company of America.[970] In return for the $300,000 which it was to pay to E. E. MacCrone & Company, The Investment Company of America was to receive 75,000 shares of the Class B stock of American Capital Corporation which had no asset value and a total market value of approximately $112,500.

On the other hand, this last aspect of the transactions for the elimination of E. E. MacCrone & Company from the management of The Investment Company of America would be advantageous to Mr. Lovelace. The 75,000 shares of the Class B stock of American Capital Corporation constituted 11% of the voting stock of that company, which then had assets of $4,000,000, and which in turn held 40% of the voting stock of Pacific Southern Investors, Inc., which then possessed assets of $5,500,000.[971] In other words, the Lovelace group, as a result of the transactions proposed, would acquire control and the management of approximately $14,000,000 of assets.[972]

Although the advisory board "did not feel that as organizer of the company [The Investment Company of America], one of the trustees, president of the company or holder of any contract with the company, Mr. MacCrone has anything to sell," [973] nevertheless, they assented to Mr. Lovelace's plan as a means of resolving the deadlock among the trustees as to the investment policy to be adopted by the investment

[969] Id., Commission's Exhibits Nos. 682, 683.

[970] Id., at 7289.

[971] Id., at 7381 and Commission's Exhibit No. 682.

[972] Including the then $4,575,000 of assets of The Investment Company of America. Mr. Lovelace conceded that this transaction resulted in his obtaining control of The Investment Company of America, American Capital Corporation, and Pacific Southern Investors, Inc. (id., at 7383). In October 1933 Mr. Lovelace caused a new The Investment Company of America to be incorporated in Delaware. To this new company all of the assets of the existing common-law trust, The Investment Company of America, were transferred. The preferred and common stockholders of the common-law trust received common stock and warrants, respectively, in the new company (id., Commission's Exhibits Nos. 687–A and 687–B). As part of this reorganization, the new company entered into a management contract for a period of 5 years with The Management Company (now known as Management Group, Inc.), a company controlled by Messrs. Lovelace, Dykema, Renfrew, and Hettinger, under the terms of which The Management Company was to receive as annual compensation 12½% of the net profits of The Investment Company of America, provided there remained an annual profit to the company equivalent to at least 6% of its investment capital. The sums obtained by The Management Company were to be reinvested in the common stock of The Investment Company of America taken at its asset value. No payment of any compensation under this agreement, however, was to occur unless and until the liquidating value of The Investment Company of America's common shares had increased to $50 a share. Such value increased to an amount exceeding $50 per share in December 1936 (ibid. and reply to the Commission's questionnaire for The Investment Company of America, Pt. IV [Item 21]). From December 31, 1935, to June 30, 1937, The Management Company and its successor, Management Group, Inc., which were controlled by Mr. Lovelace and his associates, received in management fees from The Investment Company of America a total of approximately $400,000, which was reinvested in common stock of The Investment Company of America at a price based on the asset value of such stock (Reply to the Commission's questionnaire for The Investment Company of America, Pt. I [semi-annual financial reports of The Investment Company of America]).

[973] Op. cit. supra, note 918, Commission's Exhibit No. 683. Mr. MacCrone, however, testified that he had consulted counsel, who had informed him that his various interests in The Investment Company of Ameria were legally salable assets (id., at 7281). Compare, however, the decisions of the courts with reference to the assignability of management contracts, note 62 of this section, supra.

company, particularly in view of the fact that Mr. Lovelace and Mr. Renfrew, the proposed new trustees, had agreed to a policy of repurchasing the company's debentures.[974]

In the opinion of the advisory board the payment of $300,000, which was to be made to E. E. MacCrone & Company by The Investment Company of America in return for 75,000 shares of the negative asset value Class B common stock of American Capital Corporation, represented primarily not an investment in such stock but the price for the elimination of Mr. MacCrone and Mr. Collins as trustees of The Investment Company of America.[975] This price, in the judgment of the advisory board, would be cheaper than litigation to break the existing deadlock among the trustees of The Investment Company of America—litigation which might result in the dissolution of the trust with its attendant eradication of substantially the entire investment of the trust's preferred and common stockholders.[976]

E. E. MacCrone & Company assented to this plan of Mr. Lovelace and the advisory board.[977] However, although the preferred and common stockholders of The Investment Company of America had no legal right to pass on the transaction,[978] and the advisory board on the vote of three-quarters of its members could have itself approved this self-dealing transaction between E. E. MacCrone & Company and the investment trust, the advisory board determined to submit the transaction to the preferred and common stockholders of the company for their opinion. The advisory board stated in letters written to the investment trust's shareholders on June 1 and July 16, 1932, that if a substantial number of stockholders opposed the transaction it would be abandoned. However, in response to its letters the advisory board received letters of objection from only 22 of the shareholders of the company holding 1,200 shares of the preferred and 1,290 shares of the common stock out of the outstanding 57,258 shares of preferred and 137,827 shares of the common stock of the investment trust.[979]

On August 24, 1932, the transaction was consummated.[980] The Lovelace group transferred 140,000 shares[981] of the Class B stock of

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[974] Op. cit. supra, note 918, Commission's Exhibit Nos. 682, 683.

[975] In a letter dated July 16, 1932, addressed to the preferred and common stockholders of The Investment Company of America, which described the proposed transaction for the elimination of E. E. MacCrone & Company from the management of the trust, the advisory board stated: "This is not to be viewed primarily as an investment, but as a way out of a situation arising from the many surrounding and collateral circumstances which have been referred to in these communications, and secondarily as affording a means of ultimate recovery back of the present outlay" (id., Commission's Exhibit No. 683). The latter portion of the sentence referred to the leverage in the Class B common stock of American Capital Corporation, which was a leverage investment company and which in turn held 40% of the common stock of Pacific Southern Investors, Inc., another leverage investment company (id., Commission's Exhibit No. 682).

[976] In the letter referred to in the preceding footnote the advisory board stated (id., Commission's Exhibit No. 683):

> If litigation were to be instituted and to result in liquidation the loss to shareholders would be much more than the $300,000 to be paid in the proposed transaction and there would be no opportunity to ever get it back through subsequent operation; and even if litigation stopped short of liquidation before getting through it and over the effect of it, the loss suffered by the iuterest of the shareholders would most probably exceed the $300,000.

[977] Id., at 7299.

[978] Id., at 7311.

[979] Id., Commission's Exhibits Nos. 682, 683.

[980] Reply to the Commission's questionnaire for The Investment Company of America, Pt. VII (Item 70).

[981] Op. cit. supra, note 918, at 7379.

American Capital Corporation to E. E. MacCrone & Company in return for 116,287 warrants to purchase common stock of The Investment Company of America which "were of no present value," [982] 80% of the stock of Investment Research Corporation which the Lovelace group regarded as having no value,[983] and the fiscal agency contract between E. E. MacCrone & Company and The Investment Company of America. E. E. MacCrone & Company on the same day transferred 75,000 shares of the Class B common stock of American Capital Corporation, which it had received from the Lovelace group, to The Investment Company of America for $300,000.[984]

Clearly, the net effect of this transaction was to have The Investment Company of America itself expend $300,000 for the elimination of E. E. MacCrone & Company from its management and control, and the transfer of control of the company to the Lovelace group. Mr. E. E. MacCrone conceded that the $300,000 which he had received for the sale of his warrants and other interests to the Lovelace group, had been paid to him by The Investment Company of America itself: [985]

Q. If this three hundred thousand dollars did not come out of the trust, from where did it come?

A. In the long run, of course, apparently it did come out of the trust. I do not know that as a fact, but I assume it did.

Despite the poor performance of The Investment Company of America under the sponsorship, management, and control of E. E. MacCrone & Company, Mr. MacCrone testified that he saw nothing wrong in accepting $300,000 from the investment company itself as the price of the termination of his firm's relationship with it. Mr. MacCrone testified: [986]

Q. Wasn't the net result of this transaction that there was a shrinkage from $15,000,000 to $3,000,000 under your control and domination during this period and it had to pay an additional premium of $300,000 in order that you might get out and Mr. Lovelace take it over. Isn't that the net result of the transaction? And in the judgment of these trustees it was worth apparently this additional $300,000 which brought the net assets of the trust to the point where I think a 5 percent fluctuation in the market would touch off the debentures.[987] They thought it was worth that to get rid of a management which, whether responsible or not, had been dominating over the period when this trust had lost millions of dollars.

A. As a matter of fact, the management or power over the period of time was in our friends. In other words, Mr. Lovelace himself was a trustee all of this time. He had the same responsibility that the rest of us had.

* * * * * * *

Q. You felt no qualms about taking the $300,000?

A. I thought it was a good business transaction all the way around.

Q. At the time you sponsored the trust, you took warrants as your form of compensation. All the warrant is is a guarantee that if the common stock

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[982] Id., Commission's Exhibit No. 683.

[983] Id., at 7379.

[984] Id., at 7273, 7299.

[985] Id., at 7289.

[986] Id., at 7285, 7299–7300.

[987] This means that a 5% decline in the value of the portfolio would bring the assets to a value less than 125% of the face amount of the investment trust's outstanding debentures, thus constituting a default on such debentures.

performs the way you think it is going to perform, as of the time when that performance arises, you will get your proportion out of it as a reward for proper management. At this time, however, you weren't content with that because there was no profit in the warrant and either way you were recompensed and rather handsomely so.

A. I don't consider so handsomely.

Q. You don't consider $300,000 a handsome sum at the time the trust had only $3,000,000?

A. Not for the effort we put into it during the years.

Q. How valuable had been your effort to the stockholders?

A. Well, as it worked out the efforts of nobody connected with the thing had been very helpful to it.

Mr. MacCrone further testified that the $300,000 which he received from The Investment Company of America had enabled him to meet a sufficient amount of the bank indebtedness of his firm to permit it to stay in business: [988]

A. * * * In connection with the whole business, the banks of the city of Detroit took that collateral off my loans and allowed me to re-establish myself in business.

Q. That was your whole business and not your affiliation with The Investment Company of America.

A. That was to make it possible for me to go back into business with naturally the hope that I would be able to make up whatever balance there was of loans and so forth.

On the other hand, in November 1935 The Investment Company of America sold, at a loss of $262,500,[989] the 75,000 shares of the Class B stock of American Capital Corporation which it had purchased from E. E. MacCrone & Company for $300,000.

b. To Induce Recommendation of Exchange Offers

(1) ATLANTIC SECURITIES CORPORATION—ATLAS CORPORATION

Atlantic Securities Corporation was incorporated in Delaware on August 15, 1927, under the joint auspices of F. S. Smithers & Co., Inc., A. Iselin & Company (both of whom were members of the New York Stock Exchange), Administratie en Handel Associate "Cosmos" of Amsterdam, Holland, and the New York law firm of Cotton & Franklin.[990] The corporation was created for the "purpose of investing and reinvesting its assets in a diversified group of stocks and bonds and other securities." [991] Representatives of the four sponsoring institutions constituted the entire board of directors of the corporation until May 20, 1932, when control of the corporation passed to Atlas Corporation.[992]

The original authorized capitalization of the corporation consisted of 100,000 shares of capital stock all of one class and with a par value of $100 a share.[993] Immediately on incorporation of the company, the

[988] Op. cit. supra, note 918, at 7301.
[989] Id., Respondent's Exhibit No. A.
[990] Public Examination, Atlas Corporation, at 18039, and Commission's Exhibit No. 1993.
[991] Id., at 18040, and Commission's Exhibit No. 1993.
[992] Id., Commission's Exhibit No. 1993.
[993] Ibid.

sponsors succeeded in privately disposing of 21,650 shares of the corporation's stock at a price of $105, the corporation receiving a total of $2,273,250.[994] Although the sponsors charged no commission for their services, they entered into a contract with the corporation on October 25, 1927,[995] pursuant to which the corporation agreed to issue to them, as permanent management compensation,[996] "management" option warrants to purchase an amount of shares equivalent to one-ninth of any and all shares of stock then issued or thereafter issued by the corporation. The warrants were to be exercisable at the issue price of the shares of the corporation and were to be exercisable within five years after the issuance of the shares. Pursuant to this agreement, the four sponsors each acquired a one-fourth interest in option warrants to purchase 2,405 shares of the corporation's stock on or before October 25, 1932, at a price of $105 a share.[997] In consideration of this right to the receipt of management option warrants, no salaries or other compensation was to be paid to the directors and officers of the corporation who were, as has been pointed out, nominees of the sponsors.[998]

In February 1929 the authorized capitalization of the corporation was changed to 620,000 shares of stock without par value, consisting of 120,000 shares of preferred stock and 500,000 shares of common stock.[999] The outstanding 21,650 shares of the company's stock of a par value of $100 each were converted into five shares of new common stock without par value.[1000] The company thus had outstanding 108,250 shares of common stock without par value.[1001]

Similarly, the outstanding warrants held by the sponsors of the corporation were increased fivefold in accordance with the contract of October 25, 1929, by which the sponsors were entitled to receive a warrant to purchase one share for each nine shares issued by the corporation. The option warrants to purchase 2,405 shares of the company's common stock on or before October 25, 1932, at a price of $105 a share, were exchanged for option warrants to purchase 12,027 shares of the company's common stock on or before October 25, 1932, at a price of $21 a share.[1002]

On February 15, 1929, Atlantic Securities Corporation offered to its stockholders 60,000 units of its new securities at a price of $85 a unit, each unit consisting of: (a) a share of preferred stock accompanied by a nondetachable option warrant to purchase a half share of common stock on or before March 1, 1934, at prices (graduated by year ends) from $35 to $45 a share; (b) a share of common stock; and (c) a detachable option warrant to purchase a half share of the corporation's common stock, having the same terms regarding exercisability as the nondetachable warrants. The preferred stock was entitled to cumulative annual dividends of $3 a share, was entitled

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[994] Ibid.
[995] Ibid.
[996] Id., at 18042.
[997] Id., Commission's Exhibit No. 1993.
[998] Id., at 1804, and Commission's Exhibit No. 1993.
[999] Id., Commission's Exhibit No. 1993.
[1000] Ibid.
[1001] Ibid.
[1002] Ibid.

on liquidation to a preference in assets to the extent of $52.50 and accrued dividends, and had one vote a share.[1003]

A selling group, composed of F. S. Smithers & Co., Inc., A. Iselin & Company, and International Acceptance Bank, Inc., agreed to take up and pay for such units at $85 a unit, less a 5% commission, as were not subscribed for by the stockholders.[1004] Stockholders of the corporation purchased only 6,742 of the units.[1005] On these sales the corporation realized $573,070.

In February 1929 the above-named selling group offered to the public the remaining 53,258 units of the corporation's securities at a price of $85 a unit.[1006] However, the unit which was offered to the public did not include the detachable option warrant to purchase a half share of the corporation's common stock.[1007] These detachable warrants were apparently privately distributed by the company's sponsors. The record indicates that these warrants were outstanding but were not owned by the sponsors.[1008]

As a result of the public offering the company received $4,300,583.50 ($85 a unit less 5%), and the sponsors received gross underwriting commissions totaling $226,346.50,[1009] which were divided among them as follows: A. Iselin & Company, $113,173.25;[1010] F. S. Smithers & Co., Inc., $90,538.60;[1011] and International Acceptance Bank, Inc., $22,634.65.[1012] In accordance with the agreement of October 25, 1932, the sponsors received, on the issuance of the units to the company's stockholders, warrants to purchase 749 shares of the company's common stock on or before March 1, 1934, at a price of $35 a share, and, on the issuance of the units to the public warrants to purchase 5,917 shares of the company's common stock on or before March 1, 1934, at a price of $33.25 a share.[1013]

At the conclusion of the corporation's recapitalization and after giving effect to its additional financing the corporation had received a total capital contribution of $7,146,903.50.[1014] In consideration of the receipt of these funds from its stockholders it had issued 60,000 shares of preferred stock and 168,250 shares of common stock.[1015] In addition, the corporation had outstanding in the hands of the public 120,000 option warrants to purchase 60,000 shares of its common stock on or before March 1, 1934, at prices varying from $35 to $45 a share. Of these warrants, 60,000 were attached to the preferred shares of the company and were nontransferable except in conjunction with the preferred shares; the remaining 60,000 warrants were transferable independently of the other securities of the company. Finally, the sponsors of the corporation held as management com-

[1003] Ibid.

[1004] Ibid.

[1005] Ibid.

[1006] Ibid.

[1007] Ibid.

[1008] Ibid.

[1009] Id., at 18045.

[1010] Derived from supplementary information supplied the Commission for Atlantic Securities Corporation.

[1011] Op. cit. supra, note 990, at 18041.

[1012] Derived from supplementary information supplied the Commission for Atlantic Securities Corporation.

[1013] Op. cit. supra, note 990, Commission's Exhibit No. 1993, Exhibit 10.

[1014] Id., at 18045.

[1015] Reply to the Commission's questionnaire for Atlantic Securities Corporation, Pt. II.

pensation a total of 18,693 warrants to purchase common stock of the corporation, of which 12,027 were exercisable on or before October 25, 1932, at a price of $25 a share; 5,917 were exercisable on or before March 1, 1934, at $33.25 a share; and 749 were exercisable at a price of $35 a share on or before March 1, 1934. On November 6, 1931, Administratie en Handel Associate "Cosmos," one of the original sponsors, transferred its interest in the management warrants to the International Acceptance Bank, Inc.[1016]

In the years 1931 and 1932 the corporation repurchased 9,111 shares of its preferred stock at a cost of $218,867, and, from 1929 to 1932, the corporation paid out as dividends on its preference stock $490,-959.75 Treating dividends paid and amounts expended by the corporation on its repurchases of its stock as a return of capital to the investor, the net capital contributed to the corporation was $6,237,076.75.[1017]

Throughout the management regime of the original sponsors of the corporation, the investment policies of the corporation, as outlined in the prospectus offering its shares to the public, were followed. The corporation's portfolio securities, though consisting predominantly of common stocks (which constituted in excess of 90% of the portfolio securities) were to a large extent diversified by industries.[1018] However, serious difficulties were encountered in attempting to reconcile the investment opinions of the various sponsors and managers of the corporation with reference to particular investments.[1019] Disputes as to the purchase and sale of particular securities impeded the management of the corporate assets.

As a result of these management difficulties and the collapse in security prices in 1929 the company, by April 30, 1932, had suffered a 70% shrinkage in its assets. The net assets of the company, as at April 30, 1932, were $1,927,992.73, as compared with its net contributed capital of $6,237,076.75.[1020] As at April 30, 1932, the net assets of the corporation were sufficient, if the company were dissolved, to pay only $37.87 for each share of its outstanding preferred stock. Since the preferred stock, under the company's charter, was entitled to receive $52.50 a share on liquidation of the company, the common stock of the company would not have been entitled to any share of the corporation's assets if the corporation were dissolved on or about April 23, 1932.

Obviously, as at April 30, 1932, the 18,693 management option warrants held by the sponsors of Atlantic Securities Corporation were without any actual value. They had no market value. They were exercisable at prices of $21, $33.25, and $35 a share for the common stock of Atlantic Securities Corporation.[1021] As has been stated, the common stock of Atlantic Securities Corporation had no asset value. In fact, in order for the corporation's common stock to attain an asset value equivalent to the minimum exercise price ($21) of the management warrants, the value of the assets of the corporation would have had to increase approximately $4,000,000. The market value of the

[1016] Op. cit. supra, note 990, Commission's Exhibit No. 1993.
[1017] Id., at 18045.
[1018] Id., Commission's Exhibit No. 1993.
[1019] Id., at 18046–7.
[1020] Id., at 18045.
[1021] Id.. at 1803–4 and Commission's Exhibit No. 2001 (p. 41).

common stock of Atlantic Securities Corporation was then $2 a share,[1022] as compared with the exercise prices of the warrants of $21, $33.25, and $35 a share for the corporation's common stock. The exercise of the 18,693 manager's warrants would not give to the sponsors control of the corporation in view of the fact that the corporation then had 168,250 shares of common stock outstanding. Nor could the fact that the corporation had option warrants outstanding prevent a dissolution of the corporation. First, 12,027 of the management warrants would by their terms expire on October 25, 1932, or within a six-months' period. Second, the law would seem to be that on dissolution of a corporation the holders of warrants, whether limited or unlimited in time, have only a contractual right to exercise their warrants and receive their pro rata portion of the corporate assets. They apparently cannot prevent dissolution of the corporation.[1023] That this view of the law was taken by Atlas Corporation is indicated by the fact that although it acquired the manager's warrants it made no attempt to acquire and never acquired any of the 60,000 detachable option warrants, expiring on November 1, 1934, which had been issued by Atlantic Securities Corporation in 1929. On dissolution of Atlantic Securities Corporation on December 31, 1933, Atlas Corporation made no offer of compensation to the holders of these warrants, but merely informed them of their right to exercise the warrants and thereafter to receive their distributive share of the corporate assets.[1024] None of the warrants were exercised.

Nevertheless, although the 18,693 management warrants were of no real monetary value and of no value for control purposes, they were held by the actual managers of the corporation who were in a position to oppose any attempt to acquire control of their corporation. The good will of the management, however, might be acquired by a purchase, at an attractive price, of their option warrants.

Early in May 1932, D. M. S. Hegarty and Mr. Conroy, two of the individuals engaged in finding investment companies for Atlas Corporation, suggested to Maurice L. Farrell, the president of Atlantic Securities Corporation and a partner in F. S. Smithers & Co., Inc., the possibility of shifting control of Atlantic Securities Corporation to Atlas Corporation. For their services Atlas Corporation later paid a $15,000 commission to Mr. Hegarty and a $4,500 commission to Mr. Conroy.[1025]

On April 8, 1932, F. S. Smithers & Co. Inc. and A. Iselin & Company entered into a contract[1026] with Atlas Corporation wherein it was agreed that they would recommend the acceptance by the preferred and common stockholders of Atlantic Securities Corporation of an offer of exchange of Atlas Corporation securities, the terms of which shall be described later. Atlas Corporation agreed that, if it acquired by its exchange offer 51% of the outstanding stock of Atlantic Securities Corporation irrespective of class, it would exchange 100,000 Atlas Corporation option warrants for the 18,693 warrants of Atlantic Securities Corporation held by the managers of

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[1022] Id., Commission's Exhibit No. 1993.

[1023] See Forsyth and Garner, *Stock Purchase Warrants and Rights,* 4 So. Cal. Law Rev. 385 (1931).

[1024] Op. cit. supra, note 990, Commission's Exhibit No. 1993.

[1025] Id., at 17788 and 18046.

[1026] Id., Commission's Exhibit No. 1992.

that corporation. The Atlas Corporation option warrants to be exchanged had a then market value of $125,000.[1027] Subsequently the agreement was modified to provide that Atlas Corporation would pay $150,000 in cash for the management warrants.[1028]

In essence, the agreement created in F. S. Smithers & Co. Inc. and A. Iselin & Company, both of whom had sponsored the Atlantic Securities Corporation and had underwritten and sold its securities to the public, a pecuniary interest in the acceptance of the Atlas Corporation exchange offers. It will be remembered that their "manager's warrants" had cost the sponsors nothing and represented a consideration for management which they themselves had imposed upon the stockholders as the price of their trust relationship to such stockholders. Furthermore, no offer was made by Atlas Corporation to acquire by exchange or purchase the 60,000 detachable warrants of Atlantic Securities Corporation which were held by the public. Thus, the sponsors, by virtue of their position of control had obtained from Atlas Corporation an advantage not accorded to any of the public holders of the warrants of Atlantic Securities Corporation.

The minutes of the meeting on April 8, 1932, of the board of directors of Atlas Corporation, clearly indicate that the purchase of the manager's warrants held by the sponsors of Atlantic Securities Corporation was made as an inducement for and in consideration of the recommendation by A. Iselin & Company, and F. S. Smithers & Co. Inc. of acceptance of the Atlas exchange offers by the stockholders of Atlantic Securities Corporation. The minutes recite:[1029]

> The chairman stated that subject to the approval of such proposed offer of exchange by this board, it had been suggested that it would be desirable to have such offer transmitted to the stockholders of Atlantic Securities Corporation by Messrs. A. Iselin & Company and F. S. Smithers & Company, together with their recommendations for the acceptance thereof. In connection with this suggestion, the chairman presented to the meeting a proposed agreement to be made by this corporation with A. Iselin & Co. and F. S. Smithers & Co. providing among other things that in consideration for the transmittal by A. Iselin & Company and F. S. Smithers & Company of such offer to the stockholders of Atlantic Securities Corporation, together with a recommendation for the acceptance thereof, this corporation would if and when it acquired 51 percent of the then issued shares of stock of Atlantic Securities Corporation irrespective of class, deliver to said firms option warrants to purchase 100,000 shares of common stock of this corporation in exchange for (a) the assignment to this corporation of a certain agreement dated October 25, 1927 * * * and (b) Series A, B, and C (before stock option warrants issued by Atlantic Securities Corporation) * * * to purchase certain shares of common stock of the corporation.

Mr. Odlum, when examined as to the reasons which motivated the purchase of these manager option warrants by the Atlas Corporation, testified:[1030]

> Q. And you say that the option warrants were never purchased with the intent of persuading the influential insiders to actively assist the Atlas Corporation in its exchange program?

[1027] Id., Commission's Exhibit No. 2001 (p. 143).
[1028] Id., Commission's Exhibit Nos. 1993, 2001 (p. 141).
[1029] Id., at 17795–6 and Commission's Exhibit No. 1965.
[1030] Id., at 17795–6.

A. I would say that the major reason and objective in buying option warrants, was to get the control and dominating influence out of the management and let us get in. If it had an incidental effect of making them mentally hospitable with us, all well and good, and I certainly would not throw it down for that reason.

* * * * * * *

Q. Now, as I read these minutes and I may be misreading it, Mr. Odlum, it says specifically that the motivating reason for the issuance of the 100,000 option warrants to acquire Atlas Corporation stock for the agreement and for the options was to get the cooperation of Smithers and Iselin, in connection with the exchange offer by having them send out the offer, and then recommending the acceptance, isn't that so?

A. I believe that you are misinterpreting the language of that resolution and perhaps with some foundation. I think you will find, although I can't say it definitely now, that the agreement that is referred to in that was an agreement whereby they had the management of the company and that we got the cancellation of the management contract for the thing. Now, I recollect definitely at least, of having a half dozen different conferences with Smithers in the Smithers' office on that very point, that we wanted to get in as quickly as we could to control the portfolio and they had a management contract and they had these option warrants and they weren't going to give up the management contract and keep their option warrants there, because the option warrants were given to them so that they might make them good in their own management and the only way to get them out was to buy their option warrants out.

Q. My understanding is and I may be wrong, and you may be mistaken having dealt with twenty-two acquisitions, but my understanding is that the agreement referred to was not a management contract but a distribution contract.

A. It might be, but I think they managed it too.

Q. They may have managed it, but in any event the emphasis in the minutes was not so much on the acquisition of the management contract, but in order to get the cooperation of Iselin and Smithers that the letter should go out from them, and they should actively recommend the acceptance.

A. I think it is fair to say that the minutes do place the emphasis where you state it does, but the fact is that we wanted 51 percent and we wanted control of the portfolio as soon as we got it.

On April 8, 1932, Atlas Corporation, in a circular letter to the stockholders of Atlantic Securities Corporation, offered to exchange for each share of Atlantic Securities Corporation preferred stock either (a) a unit consisting of two-thirds of a share of Atlas Corporation preference stock and an Atlas Corporation warrant, or (b) a unit consisting of four shares of Atlas Corporation common stock and an Atlas Corporation warrant. For each share of Atlantic Securities Corporation common stock Atlas Corporation offered to exchange one-third of a share of its common stock and one of its option warrants. The letter also stated "should Atlas Corporation acquire stock of Atlantic Securities Corporation hereunder then, in consideration of the assignment to Atlas Corporation of an agreement entered into by Atlantic Securities Corporation on its organization as supplemented together with the delivery to Atlas Corporation of certain stock option warrants, Series A, B, and C, issued under said agreement, Atlas Corporation will deliver to the holders of said stock option warrants

* * * its option warrants evidencing the right to purchase, as stated above, certain shares of its common stock."[1031]

A postscript to the Atlas Corporation offering letter, signed by A. Iselin & Company and F. S. Smithers & Co., stated:[1032]

> Referring to the foregoing letter addressed to you by Atlas Corporation, the undersigned recommend that the offer contained therein be promptly accepted and advise you that they will deposit their holdings of stock of Atlantic Securities Corporation in accordance with the terms of said letter.

The pecuniary interest of A. Iselin & Company and F. S. Smithers & Co., Inc., in the acceptance by Atlantic Securities Corporation stockholders of the Atlas Corporation offers, was not clearly disclosed. The ownership of the management warrants was not stated in the letter. In fact, the prospectus offering the securities of Atlantic Securities Corporation and the annual reports of the company had never clearly revealed the ownership of the warrants.[1033]

The stockholders were thus left without benefit of impartial advice on the merits of the Atlas Corporation offers from the management. The Atlas Corporation offers may have been adverse in some respects to the interests of the Atlantic Securities Corporation stockholders, for the preferred stockholders who accepted the Atlas Corporation's offer suffered a substantial loss in asset values. Under the first alternative offer made by Atlas Corporation for Atlantic Securities Corporation preferred stock (which had an asset value of $37.87 a share), Atlas Corporation was offering securities which had an asset value of $33.33 a share and a market value of $24.17 a share. Atlantic Securities Corporation stockholders who accepted the offer suffered a loss in value, as compared with the asset value of the securities they received, of $4.54 a share of their preferred stock. If the market value of the Atlas Corporation securities received be compared with the asset value of the Atlantic Securities Corporation preferred stock, the preferred stockholders who accepted the offer suffered a loss of $13.70 for each share of their preferred stock. However, the market value of the Atlas Corporation securities offered exceeded the market value of one share of Atlantic Securities Corporation preferred stock by $7.17.[1034]

The second of the alternative offers made by Atlas Corporation for Atlantic Securities Corporation preferred stock was essentially an offer of $14.44 in asset value for the $37.87 in asset value represented by the Atlantic Securities Corporation preferred stock. In other words, preferred stockholders who accepted this offer suffered a loss in assets of $23.43 on each share of their stock. The market value of the Atlas Corporation securities offered was $22.50 as compared to the asset value of $37.87 back of the Atlantic Securities Corporation preferred stock. On this basis, Atlantic Securities Corporation preferred stockholders received securities having a market value of $15.37 less than the asset value of their shares. Again, however, the market value of the Atlas Corporation securities exceeded the market value of the Atlantic Securities Corporation preferred stock.[1035]

[1031] Id., Commission's Exhibit Nos. 1970, 2001 (p. 142).
[1032] Id., Commission's Exhibit No. 1970.
[1033] Id., Commission's Exhibit No. 1993.
[1034] Id., Commission's Exhibit No. 2001 (p. 144).
[1035] Ibid.

The Atlas Corporation offer for the Atlantic Securities Corporation common stock was advantageous to Atlantic Securities Corporation common stockholders who received securities which exceeded the asset value and the market value of their shares by approximately $1.25.[1036]

As a result of its exchange offer, Atlas Corporation acquired 49,225 shares of the outstanding 50,889 shares of Atlantic Securities Corporation preferred stock and 162,618 shares of the outstanding 168,250 shares of Atlantic Securities Corporation common stock.[1037] The Atlantic Securities Corporation stockholders who made the exchange lost $110,443.24 in asset values, the difference immediately prior to the exchange, between the asset value of the Atlantic Securities Corporation stock acquired by Atlas Corporation and the asset value of the securities issued in exchange therefor by Atlas Corporation.[1038] The market value of the Atlas Corporation securities received by Atlantic Securities Corporation stockholders was $206,302.83 less than the asset value of the shares exchanged by Atlantic Securities Corporation stockholders. In other words, Atlas Corporation had obtained by the exchange offer $206,302.83 more in asset values than it would have obtained in cash if it had sold the Atlas Corporation securities given in exchange on the open market.

Ultimately, out of the gains in asset value derived by Atlas Corporation as a result of its acquisition of Atlantic Securities Corporation, Atlas Corporation was enabled to pay $150,000 in cash for the option warrants held by the sponsors, A. Iselin & Company, F. S. Smithers & Co., Inc., International Acceptance Bank, Inc., and the law firm of Cotton & Franklin—warrants which patently had no immediate value.[1039]

It is obvious from the terms of the exchange offers that Atlantic Securities Corporation preferred stockholders received fewer Atlas Corporation securities than they could have purchased with their distributive share of the corporate assets, if the corporation had been dissolved. Maurice L. Farrell, a partner in F. S. Smithers & Co., Inc., and the president of Atlantic Securities Corporation, conceded this fact but testified that the alternative of dissolution of their corporation was not offered to the preferred stockholders:[1040]

Q. Now, was there any discussion with respect to liquidating the Atlantic Securities Corporation among the directors of that corporation?

A. No.

Q. No thought was given to that at all?

A. It would have been perfectly stupid to have thought of liquidating at that time when I felt the market was practically at the bottom and it was only a matter of a few months before it was bound to turn and it would be sacrificing the stockholders.

Q. Well, if you were so convinced of the upswing why didn't you let the trust alone and let the upswing come along and take care of it?

A. For the reason I gave—I thought I gave it, maybe I didn't give it. But I thought the Atlas set-up could operate more efficiently than we could under our set-up. There was another reason. There was only a nominal market for the

[1036] Ibid.

[1037] Id., Commission's Exhibit No. 2001 (p. 146).

[1038] Ibid.

[1039] See supra, pp. 1250–51.

[1040] Op. cit. supra, note 990, at 18050–4.

shares of Atlantic Securities Corporation and there was a broad market for the shares of Atlas Corporation and if any of my stockholders wanted to get out and place their funds elsewhere, this would give them an opportunity to do so.

Q. Of course, this only gave them an opportunity to put it into Atlas?

A. They could sell their Atlas if they wanted to, convert it into cash if they wanted to.

Q. Now, on the basis of asset values, $37.87 for Atlantic preferred and an asset value of $33.33 in Atlas, there was a gain to Atlas of $4.54 and a gain in market value of $7.17 to Atlantic stockholders. That was on the first alternative. On the second alternative you had one share of Atlantic preferred with an asset value of $37.87, and they got four shares of Atlas common and one warrant with an asset value of $14.44.

A. Yes.

Q. There was a gain in assets of $23.44 to Atlas Corporation?

A. Yes, sir.

* * * * * * *

Q. If Atlantic Securities Corporation was dissolved * * * these stockholders * * * could have bought much more Atlas stock than they were getting on the exchange offer, isn't that so? If they were interested in buying Atlas stock?

A. Yes; but as I told you, we had no intention of liquidating the company.

Q. The stockholders were not consulted, then, whether they wanted to liquidate or whether the attempt should be made by the sponsors?

A. No; they were not consulted. The best answer to that is immediately the proposition was made, I think that ninety percent * * *

Q. That may be attributable to the fact that you and Iselin very actively recommended these exchanges?

A. We did, naturally.

Q. And I suppose it is natural to assume that stockholders relied upon your recommendation?

A. That is a fair assumption.

Q. The fact is, on the offer that was sent out, there was a squib signed by Iselin and Smithers that said, "referring to the foregoing letter addressed to you by Atlas Corporation, the undersigned recommend that the offer contained therein be promptly accepted," and so forth. Of course, there was no disclosure here, Mr. Farrell, that you were going to get $150,000 for the option warrants which were valueless, isn't that so?

A. I would not say they were valueless, by any means.

Q. What was the preferred stock worth? The preferred stock was under water about $12.

A. Right.

Q. The common stock had no asset value, and there had to be a recoil of $12 before there was any asset value?

A. That is right.

Q. And these warrants were exercisable at $21 a share and at $33 and $35, expiring October 25, 1932, which was just a couple of months after the offer was made; isn't that so?

A. That is correct.

Q. So as far as any value to those warrants was concerned there was none?

A. I don't agree with you.

Q. Why not?

A. If we had gone on and not liquidated the company we had in mind asking the stockholders to extend the life of these warrants, which I had no doubt they would have done.

Q. You could not have sold those warrants in the market?

A. No, sir.

Q. What you mean is, it wasn't a question of extending these warrants; you would have asked the stockholders in consideration of your continuing the management for new warrants?

A. Put it the way you like.

On May 20, 1932, Atlas Corporation acquired control of Atlantic Securities Corporation.[1041] As the result of its exchange offer Atlas Corporation had acquired all the outstanding stock of Atlantic Securities Corporation except 1,664 shares of preferred stock and 5,632 shares of common stock. By December 31, 1932, Atlas Corporation had acquired by exchange or purchase 49,667 shares of Atlantic Securities Corporation preferred stock, or 97.60%, of the 50,889 shares of Atlantic Securities Corporation preferred stock outstanding, and had also acquired 162,418 shares of the common stock of Atlantic Securities Corporation, or 96.53%, of such outstanding shares.[1042]

Without consulting minority stockholders, Atlas Corporation immediately proceeded to change the assets of Atlantic Securities Corporation from investments in a diversified portfolio of securities to investments solely in the shares of investment companies control of which was held by Atlas Corporation. On May 20, 1932, the date that Atlas Corporation acquired control of Atlantic Securities Corporation, it sold for $811,650 to the latter corporation 300,000 shares of the capital stock of Pacific Eastern Corporation, an investment company which Atlas Corporation was then in the process of acquiring. The purchase price paid by Atlantic Securities Corporation was equivalent to the cost of Atlas Corporation of the stock, but was $324,150 in excess of the then market value of the Pacific Eastern Corporation stock.[1043] In order to procure funds for the purchase of this stock from Atlas Corporation, Atlantic Securities Corporation liquidated a portion of its portfolio of diversified securities. The cost of the Pacific Eastern Corporation stock constituted 45% of Atlantic Securities Corporation's then net assets of approximately $1,800,000.[1044]

By December 31, 1932, virtually the entire portfolio of diversified securities formerly owned by Atlantic Securities Corporation had been liquidated and replaced by securities of investment companies controlled by Atlas Corporation.[1045] Of Atlantic Securities Corporation's gross assets, valued at market, of $2,314,655.05 as at December 31, 1932, $2,245,384.84 consisted of securities of Atlas Corporation controlled investment companies.[1046] As at December 31, 1933, the corporation's gross assets totaled $2,321,217.68 at market values, of which $1,912,914.25 consisted of securities of Atlas Corporation controlled companies.[1047]

[1041] Derived from supplementary information supplied the Commission for Atlantic Securities Corporation.

[1042] Op. cit. supra, note 990, Commission's Exhibit No. 2001 (p. 146).

[1043] Ibid.

[1044] Ibid.

[1045] Ibid.

[1046] Id., Commission's Exhibit No. 1993.

[1047] Ibid.

On December 29, 1933, Atlas Corporation caused Atlantic Securities Corporation to be dissolved. At that date the public held only 906 shares of the preferred stock and 3,641 shares of the common stock of Atlantic Securities Corporation. As at that date, also, net assets of the corporation valued at market prices of its portfolio securities, totaled $2,221,444.81.[1048] On this basis of valuation, the assets were sufficient to pay $43.65 on its preferred stock which was, under the charter of the corporation, entitled on liquidation of the company to $52.50 and accrued dividends which then totaled $6.25. As a consequence, the common stock had no asset value.[1049] However, if the portfolio securities of the corporation (which consisted almost entirely of securities of the Atlas Corporation controlled investment companies) were taken at their then asset values, the net worth of the corporation would be $4,117,673.57.[1050] If the assets of the corporation were evaluated on this basis, the preferred stockholders would have received $58.75 a share, the amount to which they were entitled on liquidation, and the common stockholders would have been entitled to receive approximately $7 a share for their stock.

On dissolution of Atlantic Securities Corporation, Atlas Corporation actually paid to the minority preferred stockholders the full liquidating value of their shares and paid to minority common stockholders $3 a share of their stock. The total sum necessary for this purpose was $64,150.[1051]

On the other hand, Atlas Corporation profited on its investment in the securities of Atlantic Securities Corporation to the extent of $95,292.83, if the portfolio securities of Atlantic Securities Corporaton which Atlas Corporation received on the corporation's liquidation are taken at their market value. On the basis of the asset values of the securities of Atlas Corporation controlled investment companies which Atlas Corporation received on the dissolution of Atlantic Securities Corporation, Atlas Corporation's profit on its investment in Atlantic Securities Corporation was $2,003,521.59.[1052] Atlas Corporation thus benefited from the program of investment of the assets of Atlantic Securities Corporation in the securities of other investment companies under the control of Atlas Corporation to a greater extent than did the minority common stockholders of Atlantic Securities Corporation.

c. To Induce Issuance by Acquired Corporation of its Stock to Acquiring Corporation

(1) GENERAL EMPIRE CORPORATION—ATLAS CORPORATION

General Empire Corporation, an investment company, was organized in Delaware on July 19, 1929, under the sponsorship of Hemphill, Noyes & Co., New York City investment bankers and members of the New York Stock Exchange and other securities exchanges.[1053]

[1048] Id., Commission's Exhibit No. 2001 (p. 148).
[1049] Ibid.
[1050] Ibid.
[1051] Ibid.
[1052] Ibid.
[1053] Reply to the Commission's questionnaire for General Empire Corporation, Pt. I.

The investment company was incorporated for the primary purpose, among other things, of acquiring an interest in the capital stocks of some of the leading banks and trust companies located in various communities outside New York City. The prospectus offering the shares of the company contained a list of the banks in whose stock the corporation intended to invest.[1054]

On July 22, 1929, Hemphill, Noyes & Co. and the investment company entered into a so-called stock purchase contract.[1055] Briefly, this contract provided for the purchase by Hemphill, Noyes & Co. of 100,000 shares of the corporation's capital stock at a price of $30.15 a share. Hemphill, Noyes & Co. also agreed that for two years it would provide the corporation with a president who would receive no salary and in addition would provide statistical and investment research services to the corporation free of any charge. In consideration of these undertakings upon the part of Hemphill, Noyes & Co., the corporation agreed: (a) to grant to Hemphill, Noyes & Co. until December 31, 1939, the first opportunity to underwrite or purchase all subsequent issues of the corporation's securities; (b) to issue to Hemphill, Noyes & Co. option warrants to purchase 50,000 shares of its stock until December 31, 1935, at a price of $32.50 a share; and (c) to issue to Hemphill, Noyes & Co. warrants to purchase one-half as many shares of the corporation's capital stock as were in the future to be issued by the corporation at an exercise price equivalent to the consideration per share received by the corporation on its subsequent issues of stock. The period for exercise of these warrants was to be six years from the date of each new issue of stock by the corporation.

In July 1929, Hemphill, Noyes & Co. resold to the public at $32.50 a share the 100,000 shares of the corporation's stock which they had purchased at $30.15 a share.[1056] The corporation thus realized $3,015,000. The gross underwriting commission obtained by Hemphill, Noyes & Co. was $235,000. In addition, Hemphill, Noyes & Co., pursuant to the terms of the stock purchase contract of July 22, 1929, received warrants to purchase 50,000 shares of the corporation's stock at any time up to December 31, 1935, at $32.50 a share.[1057]

Four of the nine directors of General Empire Corporation were members of the firm of Hemphill, Noyes & Co. These four directors also were four of the five members of the executive committee of the corporation.[1058] Stanton Griffis, a partner in Hemphill, Noyes & Co., became the president of General Empire Corporation.[1059]

Between July 1929 and June 1931 the corporation repurchased 10,976 shares of its own stock at a cost of $170,079.40, and paid in dividends a total of $100,000. Treating these items as capital returns, the net fund contributed to the corporation by its stockholders was $2,744,920.60. As at May 14, 1931, the assets of the corporation totaled $2,271,-512.42.[1060] The depreciation in value of the assets of the corporation totaled approximately $474,000, or 17% of the net capital contributed to the corporation by its stockholders. Apparently further losses were

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[1055] Id., Commission's Exhibit No. 1974.
[1056] Id., Commission's Exhibit No. 1975.
[1057] Id., Commission's Exhibits Nos. 1974, 1975.
[1058] Reply to the Commission's questionnaire for General Empire Corporation, Pt. I.
[1059] Op. cit. supra, note 990, Commission's Exhibit No. 1976.
[1060] Id., Commission's Exhibits Nos. 2003. 2043.

in sight in view of the financial condition of the banks whose stocks were held by the company. Not only would the failure of these banks result in their securities becoming worthless, but their stockholders might be subject to the additional losses which would result from the usual statutory liability of bank stockholders to pay assessments, for the benefit of depositors, in a maximum amount equal to the par value of the bank's securities owned by the stockholders.

In this situation continued management of the corporation was no longer attractive to Hemphill, Noyes & Co. Mr. Odlum testified, "I think they [Hemphill, Noyes & Co.] fundamentally felt that the company as they had it was too small a company to adequately handle, and in the second place that they were disgusted and didn't want to run the company and control it."[1061]

Through an intermediary, D. M. S. Hegarty, a partner in the New York brokerage firm of Hegarty & Conroy, who was eventually paid approximately $8,000 by Atlas Corporation for his services, Mr. Odlum, early in May 1931, met with Jansen Noyes and Stanton Griffis, of Hemphill, Noyes & Co., in order to negotiate for the acquisition of control of General Empire Corporation.[1062]

The firm of Hemphill, Noyes & Co. at that time owned only 10,000 shares of the stock of General Empire Corporation out of approximately 89,000 shares outstanding. The purchase of the stock would give Atlas Corporation only an 11% stock interest in General Empire Corporation. In addition, Hemphill, Noyes & Co. held warrants to purchase 50,000 shares of the General Empire Corporation stock at $32.50 a share before December 31, 1935. However, in view of the fact that the asset value of each share of General Empire Corporation stock was approximately $25 and its market value only $17, these warrants were of no immediate value. They had no quoted market value.[1063] The purchase of the stock and warrants held by Hemphill, Noyes & Co. and the exercise of such warrants by Atlas Corporation would have given it only a 47% stock interest in General Empire Corporation. Furthermore, the exercise of the warrants would involve a loss to Atlas Corporation, in addition to their purchase price, of approximately $350,000, the difference, before the exercise of the warrants, between the exercise price of the warrants and the asset value of the shares acquired.

However, Hemphill, Noyes & Co., as the controlling influence in the management of General Empire Corporation, had the power to cause the corporation to issue, for a valid consideration, authorized but as yet unissued stock of the corporation. In this power the negotiations of Atlas Corporation for control of General Empire Corporation finally centered.

About May 14, 1931, the negotiations of Atlas Corporation and Hemphill, Noyes & Co. culminated in an agreement whereby Atlas Corporation agreed to cause the sale of all of the assets of Power and Light Securities Trust, an investment trust controlled 95% by Atlas Corporation, to General Empire Corporation in consideration of the issuance by General Empire Corporation to Power and Light Securities Trust certificate holders of stock of General Empire Corporation

[1061] Id., at 17912.
[1062] Id., at 17789, 17903.
[1063] Id., Commission's Exhibits Nos. 1978, 2001 (pp. 53 and 55–6).

in an amount to be based on the asset values of the securities of the two enterprises. On this basis of exchange General Empire Corporation would be required to issue 112,852 shares of its stock for the assets of Power and Light Securities Trust.[1064] The consummation of the transaction would increase the outstanding stock of General Empire Corporation to 201,852 shares. Atlas Corporation, as the owner of 95% of the certificates of Power and Light Securities Trust would receive, of the total of 112,852 shares of General Empire Corporation stock issued for the assets of Power and Light Securities Trust, a total of 107,796 shares of the stock of General Empire Corporation, or approximately 53% of the 201,852 shares of General Empire Corporation stock which would be outstanding at the conclusion of the transaction.

As has been pointed out, the provisions of the stock purchase contract of July 22, 1929, between Hemphill, Noyes & Co. and General Empire Corporation, entitled Hemphill, Noyes & Co. to receive warrants to purchase one-half as many shares of the corporation's stock as were at any time issued by the corporation.[1065] The issuance of 112,852 shares of General Empire Corporation for the assets of Power and Light Securities Trust would, therefore, require the issuance to Hemphill, Noyes & Co. of options to purchase 56,426 shares of General Empire Corporation's stock. These options, as well as the 50,000 options already held by Hemphill, Noyes & Co., Atlas Corporation agreed to purchase. In addition, Atlas Corporation agreed to purchase the 10,000 shares of General Empire Corporation stock then owned by Hemphill, Noyes & Co.[1066]

At a meeting of the board of directors of General Empire Corporation held on May 14, 1931, three directors who were members of the firm of Hemphill, Noyes & Co. and five directors who were not associated with Hemphill, Noyes & Co., were present. The minutes reveal that Stanton Griffis, the president of the corporation and a partner in the firm of Hemphill, Noyes & Co., informed the directors of the proposed transfer of the assets of Power and Light Securities Trust to the corporation in consideration of the issuance of 112,852 shares of the corporation's authorized but as yet unissued shares, and of the further fact that Atlas Corporation would acquire control and would place its own nominees upon the board of directors of the corporation.[1067] The minutes do not indicate, however, that Hemphill, Noyes & Co. informed the independent directors that Atlas Corporation had agreed to purchase the stock and warrants held by Hemphill, Noyes & Co. The board of directors unanimously approved the purchase of the assets of Power and Light Securities Trust.

On May 18, 1931, Atlas Corporation purchased from Hemphill, Noyes & Co. the rights of that firm under its stock purchase contract of July 22, 1929, with General Empire Corporation, including the right to receive 56,428 warrants of the corporation as the result of the issuance by the corporation of 112,856 shares of its stock for the assets of Power and Light Securities Trust. The purchase price was $40,000. In addition, Atlas Corporation purchased the original 50,000 warrants

[1064] Id., Commission's Exhibits Nos. 1978, 2001 (pp. 50 and 52–3).
[1065] Id., Commission's Exhibit No. 1974.
[1066] Id., Commission's Exhibits Nos. 1978, 2001 (p. 55).
[1067] Id., Commission's Exhibit No. 1979.

held by Hemphill, Noyes & Co. at $5.25 a warrant or a total consideration of $262,500. Atlas Corporation also purchased at $17 a share, the then market price, the 10,000 shares of General Empire Corporation owned by Hemphill, Noyes & Co. The total sum paid to Hemphill, Noyes & Co. was $472,500, of which $302,500 was paid for the warrants which had cost Hemphill, Noyes & Co. nothing and which, as has been pointed out, had no immediate actual value.[1068] The consideration received for the warrants more than compensated Hemphill, Noyes & Co. for any losses it had suffered on its holdings of 10,000 shares of the corporation's stock. If it be assumed that the 10,000 shares were purchased at the original issue price of $30.15 a share, the loss on these shares would have been $131,500. The firm received $302,500 for its warrants. In addition, Hemphill, Noyes & Co. received a substantial amount of brokerage business from Atlas Corporation,[1069] and, for a commission, later actively solicited General Empire Corporation stockholders to exchange their shares for shares of Atlas Corporation.[1070]

On the same day, May 18, 1931, minority certificate holders of Power and Light Securities Trust were informed that, pursuant to an "Agreement of Reorganization"[1071] between the trustees of their trust and General Empire Corporation, all of the assets of Power and Light Securities Trust would be conveyed to General Empire Corporation in consideration for the issuance of 112,856 shares of General Empire Corporation stock and that Power and Light Securities Trust would be dissolved and the General Empire Corporation stock distributed to the certificate holders of Power and Light Securities Trust.[1072]

On June 3, 1931, all of the assets of Power and Light Securities Trust were conveyed to General Empire Corporation.[1073] As a result, Atlas Corporation acquired 107,796 shares of General Empire Corporation stock which gave it control of the latter corporation.[1074] On the same day, all of the directors of General Empire Corporation, with the exception of Stanton Griffis, resigned and were replaced by representatives of Atlas Corporation.[1075]

Mr. Odlum testified that from his point of view the only purpose of the transaction was to procure control of General Empire Corporation for Atlas Corporation, and that it "could have been" possible that, because Atlas Corporation was purchasing their warrants, Hemphill, Noyes & Co. was thereby induced to approve the transaction whereby Atlas Corporation acquired control of General Empire Corporation.[1076]

Q. Now in some of the other cases that we have seen, Mr. Odlum, the situation was you purchased big blocks of stock from the sponsor. I can see in those instances (although it is our position that by virtue of this control of big blocks, particularly if he is the sponsor or principal underwriter, that he may

[1068] Id., Commission's Exhibit No. 2001 (p. 55).
[1069] See infra, pp. 1304–5.
[1070] Op. cit. supra, note 990, Commission's Exhibit No. 2037.
[1071] Id., Commission's Exhibit No. 1977.
[1072] Id., Commission's Exhibit No. 1973.
[1073] Ibid.
[1074] Id., Commission's Exhibit No. 2001 (p. 56).
[1075] Id., Commission's Exhibit No. 1977.
[1076] Id., at 17913–4, 17917–21.

have some obligations even with respect to the disposition of that block, and I think you feel almost the same way about that)——

A. Yes; depending upon the facts and circumstances.

Q. Yet he is dealing with his own property and if that entails the passage of control to the Atlas Corporation, it is uncontrollable. He says, "I have no alternative in the matter. Extenuating circumstances demand I do it." And he sells his own property, isn't that so?

A. Yes.

Q. And then you get control. But in this case Hemphill, Noyes was not selling you a single share of their own stock—I mean as part of the transaction to give you control; they did sell you some of their own stock, and I will come to that, but I mean actually you were not buying their stock.

A. No.

Q. So basically this was a situation where Hemphill, Noyes took it upon themselves to pass control to Atlas Corporation, not by selling their own stock but by selling the corporation's stock, isn't that so?

A. Well, the directors of General Empire did.

* * * * * * *

Q. I assume, Mr. Odlum, you are also not unmindful of the stock purchase agreement, whereby Hemphill, Noyes, who were the original sponsors and principal underwriters, had an arrangement whereby for every share of stock they sold originally they got half an option warrant and after that received half an option warrant for each share subsequently issued and sold by the investment company?

A. I know of the existence of that agreement.

Q. You knew it at the time you discussed it with Hemphill, Noyes?

A. I found it out during the discussion.

Q. Otherwise you would have found yourself in a situation where there were 50,000 additional option warrants that you did not know existed?

A. I knew those would have to be issued.

Q. And you do know, Mr. Odlum, that these option warrants—and that was not only true of this case, but it was true, I think you know, historically in all cases where option warrants were given in connection with the distribution of securities—those option warrants not only covered distribution compensation, but management compensation. Isn't that so?

A. In whole or in part.

Q. * * * In any event you were considering at the time when you made this arrangement that Hemphill, Noyes would get a half option warrant for every share of stock issued you in consideration of the purchase of all of the assets of Power and Light?

A. Yes.

Q. And you were also conscious of the fact that as soon as that happened, Hemphill, Noyes was out of the management, because that was the very purpose of this deal to get them out—isn't that so?

A. That is right.

Q. And then we have this situation that the sponsors—or at least Hemphill, Noyes & Co., who were the dominant personalities in that picture, were the only ones with whom you carried on the negotiations?

A. Yes.

Q. The dominant personalities in General Empire Corporation decided themselves, without consulting their stockholders, that they were going to transfer control of the General Empire Corporation, control of the management, to Atlas Corporation, and by that very act of transferring control, were to get

half an option warrant for every share of stock that was issued. And, as I recall it, there were issued 56,426 option warrants, so that there were approximately 113,000 shares of stock issued for the assets?

A. Yes.

Q. So that the very act by which these individuals—Hemphill, Noyes—transferred control to the Atlas was the very act which gave them 56,000 option warrants?

A. Yes. If you had Hemphill, Noyes or one of their partners here and asked that question he would not answer it "yes." If I were answering it for him, I would not do it either.

Q. How would you answer it?

A. I would say that the passage of control to Atlas and the loss of their management were incidents of the issue of stock for property. It so happened in this case that one buyer acquired enough of that stock to get control, and that that buyer as an incident of getting that, wanted the management.

Q. Would you have gone through this transaction if the sale had not given you 51%? You were not getting a minority interest?

A. Oh, yes. I probably would, but I would not have gone through with it if I had not gotten the management.

Q. Well, in any event, I don't think I phrased my question properly as far as you are concerned—I may have phrased it properly as far as Mr. Noyes is concerned. I did not phrase my question, as far as you are concerned, with the inference that one was done to effect the second, but there is no doubt that they were contemporaneous in time?

A. Yes; we did it to get management and control. They did it as a corporate act which they thought good for the stockholders and to get rid of it.

Q. And also to sell you the option warrants that they got contemporaneously with the passage of control because that is what transpired?

A. It could have been that.

Mr. Odlum further testified:[1077]

Q. You were trying to get, shall I say, a fair deal for your stockholders of the Atlas Corporation and of Power and Light Securities Trust?

A. Yes; we dealt at arm's length.

Q. You dealt at arm's length with Hemphill, Noyes; the question is did Hemphill, Noyes in dealing at arm's length with you, deal at arm's length with their stockholders?

A. They dealt at arm's length with me for their stockholders.

Q. That is as far as your viewpoint is concerned. But there is no doubt that simultaneously or contemporaneously these sponsors got $302,500 for some option warrants they had; isn't that so? You can conceive, can you not, of the remote possibility that that may have been a factor in the consideration of some individuals leaving out the name Hemphill, Noyes?

A. I can conceive that the personal sale of some assets held could under some circumstances influence a man's judgment—but I am sure it didn't in this case.

Stockholders of General Empire Corporation were not consulted with reference to the amalgamation of Power and Light Securities Trust with their corporation.[1078] In fact, they were probably not aware that Atlas Corporation had acquired control of their company

[1077] Id., at 17931.
[1078] Id., at 17908.

until they received on June 4, 1932, an offer of exchange from Atlas Corporation.[1079] They never were informed of the sale of the warrants of Hemphill, Noyes & Co. to Atlas Corporation.

The stockholders of General Empire Corporation, who had been led to believe that the corporation invested primarily in bank stocks, as a result of the transaction became stockholders of a corporation which, after it had absorbed the assets of Power and Light Securities Trust, held a large amount of utility securities.

The minority certificate holders of Power & Light Securities Trust had no alternative but to accept the General Empire Corporation stock which they received on the dissolution of their Trust. The certificate holders then found themselves stockholders of a corporation which had a heavy investment in bank stocks.

Finally, the security holders of both enterprises were stockholders in a subsidiary of a corporation whose then principal business was the acquisition of investment companies. In fact, General Empire Corporation, under the control of Atlas Corporation, to a large extent liquidated its portfolio of bank and utility shares and concentrated its investments in the securities of other Atlas Corporation controlled investment companies. As at June 21, 1933, the date of the dissolution of General Empire Corporation, investments by General Empire Corporation in other Atlas Corporation controlled investment companies had a market value of $2,641,279.13 and constituted approximately 71.6% of the total market value of General Empire Corporation's portfolio.[1080]

That General Empire Corporation stockholders may have invested in its securities in reliance on the fact that it would invest in bank stocks, is apparent from a letter [1081] written on June 23, 1932, from the Albany office of Hemphill, Noyes & Co. to its New York offices, seeking guidance as to the answers to several questions raised by stockholders who were being solicited to exchange their General Empire Corporation stock for Atlas Corporation stock. The letter stated:

> Another question is as follows: When we bought this General Empire stock, it was done so on the understanding that it was to be largely composed of bank stocks outside of greater New York City, and the company several times showed that it owned stock in about forty banks. The last statement * * * included only three bank stocks that I could find. Would you please tell me what became of the bank stock and why?

Although the absorption of Power and Light Securities Trust by General Empire Corporation took the form of a purchase of the former's assets by the latter, factually, if not legally, the transaction constituted a merger or consolidation of the two enterprises. Yet, since Power and Light Securities Trust was a common law trust created under an indenture permitting its trustees to alienate the entire assets of the corporation upon the consent of 75% of the trust's security holders,[1082] dissenting security holders did not have

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[1079] Id., Commission's Exhibits Nos. 1970, 2037.

[1080] Id., Commission's Exhibit No. 2039. The total market value of the company's portfolio as at this date was $3,690,156.33 (ibid.).

[1081] Id., Commission's Exhibit No. 2037 (Item 28).

[1082] Id., Commission's Exhibit No. 1971.

the right accorded in most states in a similar situation to stockholders of a corporation to receive in cash the appraised value of their securities.[1083] Similarly, since the transaction did not take the form of a technical merger or consolidation, General Empire Corporation's directors who had the power under its charter to purchase securities were not required to obtain the approval of General Empire Corporation's stockholders to the transaction. Nor were stockholders of General Empire Corporation, who might have dissented to the acquisition of the assets of Power and Light Securities Trust, privileged in law to receive an appraised value of their General Empire Corporation shares.[1084] In fact, not until 1937 [1085] did the Delaware law grant a privilege to dissenting stockholders to receive an appraised value of their shares on a technical merger or consolidation of their corporation with an unincorporated entity such as Power and Light Securities Trust. The method adopted by Atlas Corporation to acquire control of General Empire Corporation thus, in effect, eliminated any necessity for the approval of the transaction by security holders of either of the amalgamated companies. Mr. Odlum testified: [1086]

Q. Now, Power and Light was a Massachusetts trust which is not different, substantially, from a common-law trust, I might say?

A. Yes * * *.

* * * * * * *

Q. And in that respect it was different from a corporation, because in the case of a corporation, if you had a voluntary consolidation or merger, the stockholder would have the statutory right of appraisal if he dissented; isn't that so?

A. Yes.

Q. In the case of a Massachusetts trust, if the requisite number of certificate holders approved the sale of all the assets and the trustees effected the sale, of course, the other certificate holders had no recourse; isn't that so?

A. I am not sure what all the rights are in the trust, but I think likely—my recollection is that in the case of a Massachusetts trust the whole control is vested in the trustee.

* * * * * * *

Q. So that within a few months after you acquired Power and Light you were undertaking negotiations to sell the assets of Power and Light to General Empire Corporation; isn't that so?

A. Yes; from the practical standpoint, it was a consolidation of the two, although it was not in that legal form.

Q. Now, ordinarily where you make an exchange offer the individual stockholder had the right to determine whether he was going to accept the exchange or not; isn't that so?

A. Yes.

Q. And, therefore, he had the right to determine whether he was going to become a stockholder of Atlas or not?

A. Yes.

Q. Except in this situation, where Atlas acquired the requisite number of stocks of each class to effect a statutory consolidation, if a stockholder didn't

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[1083] See infra, pp. 1421–23.

[1084] See ibid.

[1085] Del. Rev. Code (1935, as amended), Ch. 65, § 59 (b) and § 61.

[1086] Op. cit. supra, note 990, at 17903–10, 17913.

go through the statutory formula of dissenting and asking for an appraisal within the statutory period, he would become a stockholder of Atlas by operation of law?

A. Correct.

Q. But in the first instance there was an element of volition on his part as to whether he would become an Atlas stockholder or not, isn't that so?

A. Yes.

Q. Now, the mechanics as worked out in General Empire Corporation case, eliminated that element of volition or choice, at least on behalf of the remaining stockholders of the Power and Light, isn't that so?

A. I am not so sure it eliminated that, because I don't know whether there was a vote or not, but in any event, we owned at the time 95% of the stock.

Q. All right. Now, General Empire Corporation was going to be part of your ultimate plan and was going to form part of your whole picture, isn't that so?

A. That was our idea. That was our approach to it.

* * * * * * *

Q. But ultimately it was contemplated that General Empire Corporation be dissolved as an entity?

A. Yes; just as in all other cases.

Q. Now, what happened, Mr. Odlum—an arrangement was made whereby the General Empire Corporation would issue new stock to the Power and Light Trust which you controlled at that time?

A. Yes.

Q. In consideration of the transfer of all the assets of Power and Light to the General Empire Corporation, isn't that so?

A. Correct.

Q. And the amount of shares that General Empire Corporation was willing to pay for the transfer of assets amounted in fact to over 51% of all the outstanding General Empire Corporation shares?

A. That is correct, I believe.

Q. So that here you had a situation where ultimately, at least, it was intended to dissolve the General Empire Corporation and an agreement was made whereby a controlling block of stock was going to be turned over to Power and Light, which is Atlas, isn't that so?

A. Yes.

* * * * * * *

Q. And that would put the Atlas Corporation, would it not, in the position, if it acquired sufficient stock to equal the statutory amount to liquidate that trust, dissolve it, merge it, or sell all the assets, isn't that so?

A. It would put us in majority control of General Empire Corporation.

Q. And in order to consummate this transaction, namely, turn over to Atlas Corporation a controlling interest in the General Empire Corporation, the officers and directors and sponsors did not have to ask the stockholders whether they would do it, because the directors had the right to purchase assets for stock?

A. I believe that is true.

Q. And as far as the Power and Light was concerned, since Mr. Hatch and Mr. Johnston [directors of Atlas Corporation] were the majority of the three trustees, they could sell all the assets of the Power and Light Securities Trust to the General Empire, isn't that so?

A. Yes.

Q. So we have a transaction by which the General Empire officers, or rather, the directors of the company, issue to the Atlas Corporation stock in an amount to give the Atlas Corporation actual voting control of the situation, and the Power

and Light trustees could sell all of the assets to General Empire without consulting even the small minority certificate holders of Power and Light, isn't that so?

A. I believe it is.

Q. And without consulting or getting the acquiescence or consent of a single stockholder of the General Empire Corporation, although at the time you commenced your negotiations with Hemphill, Noyes, you did not own a single share of General Empire Corporation?

A. They had already gotten that consent from the stockholders of the General Empire if they had authorized the stock to issue.

Q. But ordinarily, Mr. Odlum, you don't issue stock to raise capital to immediately liquidate the trust, do you?

A. No, sir; and that wasn't the purpose either.

Q. Well, the ultimate purpose was to liquidate the trust. It wasn't a case where the officers and directors of the General Empire Corporation felt they needed more capital, and this was a medium of raising more capital. This is just a device whereby the control of General Empire was transferred—and I am not saying it wasn't in their best judgment. But this transaction was just the mechanics that was used to turn over control of General Empire to Atlas?

A. To turn over the management; yes.

Q. And that was effected without consulting the stockholders of General Empire, isn't that so?

A. I believe so, I was not on that side of the trade.

* * * * * * *

Q. And with that kind of mechanics then it wouldn't be necessary to consult the stockholders of General Empire as to whether they wanted to be part of the bigger picture, isn't that so?

A. That is true, but that wasn't making them a part of the bigger picture, it was merely putting Power and Light and General Empire together.

Q. And, of course, putting them as a subsidiary of Atlas Corporation.

A. Yes.

Atlas Corporation increased its holdings of General Empire Corporation stock by purchases in the market largely through Hemphill, Noyes & Co. As at November 5, 1931, Atlas Corporation had acquired a total of 144,588 shares of General Empire Corporation stock at a book cost of $3,865,669.96,[1087] or at an actual cost, after deducting the net gain of $155,560 [1088] in assets to Atlas Corporation on its exchange offer for Power and Light Securities Trust certificates, of approximately $3,710,000. On November 5, 1931, Atlas Corporation sold, for a total consideration of $2,968,396, these holdings of General Empire Corporation to three of its subsidiaries: Chain Store Stocks, Inc., which purchased 48,700 shares; National Securities Investment Company, which purchased 73,000 shares; and Securities Allied Corporation, which purchased 22,288 shares.[1089] The warrants purchased from Hemphill, Noyes & Co. were also transferred to these subsidiaries which charged them off on their books as worthless.[1090] Atlas Corporation suffered a book loss on these intercompany transactions of ap-

[1087] Id., Commission's Exhibit No. 2001 (p. 57).

[1088] Id., Commission's Exhibit No. 2001 (pp. 47 and 50). The total unrealized gain to Atlas Corporation as a result of its exchange offer for the securities of Power and Light Securities Trust was $479,505.20. A total of $323,945 was paid out to Hale, Waters & Company in connection with the consummation of the exchange offer (ibid.).

[1089] Id., Commission's Exhibit No. 2001 (p. 58).

[1090] Ibid.

proximately $742,000. However, Atlas Corporation acquired by the transactions available cash with which to acquire control of other investment companies.

On June 4, 1932, as one of 12 similar offers of exchange made to stockholders of its subsidiary companies, Atlas Corporation offered to exchange one and one-fifth shares of its common stock for each share of the capital stock of General Empire Corporation.[1091] The offer informed General Empire Corporation stockholders that the asset value of each of their shares was approximately $7, based on the market value of the portfolio of their company, but stated further that, if the securities of Atlas Corporation controlled investment companies in the General Empire Corporation portfolio were valued at their asset value, the asset value of each General Empire Corporation share would be approximately $9.50 a share.[1092] The shares of Atlas Corporation offered in exchange for each share of General Empire Corporation stock had an asset value of $3.56. This asset value of the Atlas Corporation stock to be exchanged was not revealed in the offering circular.

However, the offering letter of Atlas Corporation did state that the asset value of the Atlas Corporation's common stock would be $7.30 a share (or $8.76 for one and one-fifth shares of such stock) if all of the stockholders of its 12 subsidiary investment companies accepted its exchange offers. On the basis of this hypothetical asset value for the common stock of Atlas Corporation, stockholders of General Empire Corporation who accepted the offer would suffer an asset loss of 74 cents a share of their General Empire Corporation stock which, as has been stated, had an underlying asset value of $9.50 a share.

In terms of market values, the acceptance of the offer would result in a gain of 50 cents per share of their stock to General Empire Corporation stockholders.

As a result of this offer, acceptance of which was actively solicited by Hemphill, Noyes & Co. in consideration of commissions paid to it by Atlas Corporation,[1093] Atlas Corporation acquired 43,467 shares of General Empire Corporation stock, and the gross asset loss to General Empire Corporation stockholders who accepted the offer was approximately $149,470 on the basis of an asset value of $3.56 for the Atlas Corporation securities which they received in exchange for their shares.[1094]

On June 6, 1933, when General Empire Corporation was dissolved, Atlas Corporation and its subsidiaries, Chain Store Stocks, Inc., National Securities Investment Company, and Securities Allied Corporation, held a total of 200,047 shares of the capital stock of the corporation, or approximately 99% of its outstanding stock,[1095] and Atlas Corporation and its subsidiaries received on the dissolution of General Empire Corporation cash and securities with a value of approximately $4,823,000,[1096] taking the securities of Atlas Corpora-

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[1091] Id., Commission's Exhibits Nos. 1970, 2001 (p. 59), 2037.

[1092] Id., Commission's Exhibit No. 1970.

[1093] Id., Commission's Exhibit No. 2037.

[1094] Id., Commission's Exhibit No. 2001 (p. 60). However, General Empire Corporation stockholders who accepted this offer, by becoming stockholders of Atlas Corporation recovered a portion of their losses in asset value.

[1095] Id., Commission's Exhibit No. 2001 (pp. 60–1).

[1096] Ibid.

tion controlled investment companies received at their then asset values. The actual cost of the investment by Atlas Corporation and its subsidiaries in General Empire Corporation's stock was approximately $4,665,000,[1097] so that an unrealized profit of approximately $158,000 was derived by Atlas Corporation and its subsidiaries on their investment in General Empire Corporation as of the date of the dissolution of General Empire Corporation.

(2) AVIATION SECURITIES CORPORATION—ATLAS CORPORATION

Aviation Securities Corporation was incorporated in Delaware on November 26, 1928, under the auspices of Field, Glore & Co. of Chicago and New York City, James C. Willson & Company of New York City, both of whom were investment brokers, and Mander Investment Company, a privately owned company of which Earle H. Reynolds was president. Earle H. Reynolds, Charles F. Glore, and James C. Willson became directors of the corporation. Aviation Securities Corporation was organized to invest and reinvest its funds in aviation securities and to assist financially and technically in the development of new aviation companies.[1098]

On November 28, 1928, the corporation entered into an agreement with its sponsors, Field, Glore & Co., Mander Investment Company, and James C. Willson & Company, wherein the sponsors, in consideration for the receipt of option warrants to purchase at $20 a share on or before December 31, 1931, 100,000 shares of the corporation's stock, "agreed to find purchasers" for 150,000 shares of the corporation's stock at $20 a share. It was agreed that, in lieu of finding purchasers for 75,000 shares, the corporation would accept therefor 5,000 shares of the capital stock of National Air Transport, Incorporated.[1099]

On December 7, 1928, X CO Corporation, of which Earle H. Reynolds was president, transferred to Aviation Securities Corporation 5,000 shares of the stock of National Air Transport, Incorporated, in consideration for the receipt of 75,000 shares of the stock of Aviation Securities Corporation.[1100] The 5,000 shares of National Air Transport, Incorporated, constituted 16⅔% of the total shares of such company then outstanding.[1101] Earle H. Reynolds was the president of National Air Transport, Incorporated.[1102] Aviation Securities Corporation valued these shares on its books at $1,750,000, their then market value based on the then prevailing over-the-counter price of the National Air Transport, Incorporated, stock.[1103] This transaction between X CO Corporation and Aviation Securities Corporation, in effect, enabled X CO Corporation to sell to the public one-sixth of the capital stock of National Air Transport, Incorporated, at the then prevailing over-the-counter price for the stock of the transport company. It does not appear whether or not investors

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[1097] Ibid.

[1098] Op. cit. supra, note 990, Commission's Exhibit No. 1998, Items 1, 4, 5.

[1099] Ibid.

[1100] Ibid. The 5,000 shares of common stock of National Air Transport, Incorporated, constituted the entire assets of X CO Corporation (ibid.).

[1101] *Moody's Manual of Investments, Industrials,* 1929, p. 1768.

[1102] Ibid.

[1103] Op. cit. supra, note 990, Commission's Exhibit No. 1998 (Item 3).

who ultimately purchased the shares of Aviation Securities Corporation were informed of this transaction.[1104]

The 75,000 shares of Aviation Securities Corporation stock so obtained by X CO Corporation and an additional 75,000 shares of the company's stock, a total of 150,000 shares, were offered to the public on December 10, 1928, by Brokaw and Company of Chicago at $23.50 a share.[1105]

The total capital raised by Aviation Securities Corporation on the issuance of 150,000 shares of its capital stock was $3,250,000.[1106]

Each of the sponsors of the corporation retained 16,667 of the 100,000 warrants which they had received from the corporation in consideration for their agreement to find purchasers for the company's stock. Of the remaining warrants, 25,000 were transferred to National Aviation Corporation in consideration for that company's agreement to furnish Aviation Securities Corporation with investment advice and other information with reference to aviation securities. The remainder of the warrants were distributed by the sponsors to the 21 directors of Aviation Securities Corporation apparently as consideration for their services as directors.[1107]

Options to purchase 500 shares of the company's stock were exercised in 1929. The company thereby raised an additional $10,000, increasing the total capital contribution made to the company to $3,260,000.[1108]

However, from 1929 to 1931, the corporation repurchased 36,500 of its own shares at a total cost of $556,307.98. As will be seen later, 20,000 of these repurchased shares were sold to Atlas Corporation for $240,000. The remaining 16,500 shares were retired by the corporation.[1109] The cost of these retired shares was $316,307.98.[1110] Treating the cost of these retired shares as a return of capital to the company's stockholders, the net capital contributed to the corporation was $2,943,692.02.

During the first year of its existence the corporation invested almost exclusively in aviation securities.[1111] Its investment in National Air Transport, Incorporated, alone constituted in excess of 50% of its assets.[1112] However, by the middle of 1930 the corporation had disposed of nearly all of its investments in aviation stocks, including its investment in National Air Transport, Incorporated, which was sold at a profit of approximately $700,000, and had replaced them with a diversified portfolio of securities.[1113] This shift in investment policy was disclosed by the management to the company's stockholders in the annual report of the company for the year 1930.[1114]

[1104] The listing bulletin for the stock of Aviation Securities Corporation on the New York Curb Exchange did not reveal the transaction between Aviation Securities Corporation and a company affiliated with one of its sponsors, Earle H. Reynolds.

[1105] *Moody's Manual of Investments, Banks, etc.*, 1932, p. 1232.

[1106] Op. cit. supra, note 990, Commission's Exhibit No. 2003.

[1107] Id., Commission's Exhibit No. 1998 (Items 7 and 8).

[1108] Id., Commission's Exhibit No. 2000 (Exhibit A).

[1109] Derived from supplementary information supplied the Commission for Aviation Securities Corporation.

[1110] Op. cit. supra, note 990, Commission's Exhibit No. 2003.

[1111] Ibid.

[1112] Id., Commission's Exhibit No. 2000.

[1113] Ibid., and derived from supplementary information supplied the Commission for Aviation Securities Corporation.

[1114] Op. cit. supra, note 990, Commission's Exhibit No. 2000.

As at December 31, 1931, the approximate date that Atlas Corporation acquired a majority of the shares of Aviation Securities Corporation, the assets of the company totaled $1,725,210.[1115] The company had suffered realized and unrealized losses of $1,218,481.[1116] These losses totaled approximately 40% of the company's net contributed capital of $2,943,692.

Negotiations between Atlas Corporation and Field, Glore & Co. looking toward Atlas Corporation's acquiring an interest in Aviation Securities Corporation, were commenced in the fall of 1930.[1117] Mr. Odlum testified that it was not the intention of the management of Aviation Securities Corporation that Atlas Corporation acquire control of Aviation Securities Corporation. Rather, according to Mr. Odlum, the management of Aviation Securities Corporation intended that Atlas Corporation should remain in a minority stockholder's position in Aviation Securities Corporation and aid that corporation by its advice and suggestions on investments.[1118] Mr. Odlum's intention, which he testified he did not disclose to Field, Glore & Co. and to the management of Aviation Securities Corporation, was to acquire control of, and eventually to absorb Aviation Securities Corporation.[1119]

Apparently, Field, Glore & Co.'s only security interest in Aviation Securities Corporation was its ownership of a block of the company's outstanding warrants. Atlas Corporation desired, therefore, to acquire control of all or part of the 36,500 shares of Aviation Securities Corporation's stock held in the treasury of the corporation. Field, Glore & Co. apparently was desirious of selling to Atlas Corporation the warrants owned by itself and Mr. Glore personally, and the warrants held by other influential directors of Aviation Securities Corporation. As has already been pointed out, these warrants entitled their holders to purchase stock of Aviation Securities Corporation at a price of $20 a share until December 31, 1931. In other words, the warrants would expire in about a year. That the warrants were of little actual value is evident from the fact that the asset value of the stock purchasable under the warrants was $18.62[1120] a share and the market value of such stock was $12 a share.[1121] The evidence indicates that Mr. Odlum, himself, believed that these warrants were of no real value to the sponsors. In a cablegram dated October 7, 1930, from Mr. Odlum to L. Boyd Hatch, a director and vice president of Atlas Corporation, Mr. Odlum stated:[1122]

Your letter from Chicago about Aviation Stop If you could get management and say fifty or sixty thousand shares around fifteen or sixteen would pay $2.50 for options Stop Above based on figures your letter which probably can be all correspondingly reduced on account subsequent market decline Stop Doubt greatly if market values on investment trusts will climb sufficiently to make these short term warrants of any real value to present owners Stop They

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[1115] Id., Commission's Exhibits Nos. 2000, 2003.
[1116] Id., Commission's Exhibit No. 2003.
[1117] Id., at 18071.
[1118] Id., at 18073.
[1119] Id., at 18073–5.
[1120] Ibid.
[1121] Id., at 18072 and Commission's Exhibit No. 2001.
[1122] Id., at 18076 and Commission's Exhibit No. 1995.

have value for purpose control only and would hope to buy sufficient shares below liquidating value so that shares plus options would not cost more than liquidating value of shares thus giving us first control of additional capital and second a profit in working out the remaining shares.

Although these warrants were worthless, their purchase from influential directors and from the sponsors of Aviation Securities Corporation might serve as an inducement to these individuals to authorize the sale of a large block of the investment company's treasury stock to Atlas Corporation at a price sufficiently below their asset value to enable Atlas Corporation to retrieve the loss it would suffer by purchasing the warrants. A letter dated November 25, 1930, written by John W. Donaldson, a vice president of Atlas Corporation, to Charles F. Glore of Field, Glore & Co., one of the sponsors of Aviation Securities Corporation, after pointing out that Mr. Odlum was in Europe, and that final determination of the negotiations would have to await his return, went on to state:[1123]

In the meantime, would it be possible for you to let us know the number of warrants which you think can be purchased and the price. We must confess that we are somewhat skeptical about the value of these warrants at the present time, owing to the very short time they have to run and the rather distinct possibility that there will not be any very great recovery in the market over the next year. In view of this fact, we are interested in determining whether it would be possible for us to be granted an option on the treasury stock at somewhat below liquidating value, along with and in consideration of these warrants.

On January 26, 1931, Aviation Securities Corporation sold to Atlas Corporation 20,000 shares of its treasury stock at $12 a share, the market price, for a total consideration of $240,000.[1124] The asset value of this stock, as has been stated, was then $18.62 a share, so that the sale meant a gross loss in asset values to stockholders of Aviation Securities Corporation of $132,400. Atlas Corporation gained this spread in asset value. However, on February 5, 1931, Atlas Corporation purchased from a group of the directors and sponsors of Aviation Securities Corporation 43,834 warrants of Aviation Securities Corporation at a price of $3 a warrant or a total consideration of $131,502.[1125] Thus, the gain in asset value derived by Atlas Corporation on the purchase of the 20,000 shares was almost equal to the cost of these warrants purchased by Atlas Corporation. The asset gain to Atlas Corporation on its purchase of the treasury stock of Aviation Securities Corporation for a price less than the stock's liquidating value was in effect paid to the directors of Aviation Securities Corporation who sold their warrants to Atlas Corporation. In other words, the asset value gain, which Aviation Securities Corporation's stockholders would have derived if the treasury stock purchased by Atlas Corporation had been retired, was actually realized, not by the stockholders, but by the directors who sold their warrants to Atlas Corporation.

The 43,834 warrants of Aviation Securities Corporation were purchased by Atlas Corporation from the following directors and spon-

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[1123] Id., Commission's Exhibit No. 1996.

[1124] Id., Commission's Exhibit No. 2001 (p. 74).

[1125] Id., at 18082 and Commission's Exhibit No. 2001 (pp. 74–5).

sors of Aviation Securities Corporation: Earle H. Reynolds, John Wentworth, Laurance H. Armour, Charles F. Glore, Walter B. Wolf, Field, Glore & Co., and Mander Investment Company.[1126] As has previously been pointed out, Earle H. Reynolds was the president of Mander Investment Company. These five directors participated in the unanimous approval by the 10 directors present at a meeting[1127] of the board of directors of Aviation Securities Corporation held on January 27, 1931, of the sale of the 20,000 shares of treasury stock to Atlas Corporation. The sale of their warrants by these directors to Atlas Corporation was apparently never revealed to the stockholders of Aviation Securities Corporation in any notice, statement, or report to these stockholders.

The 20,000 shares purchased by Atlas Corporation from Aviation Securities Corporation itself constituted approximately 15% of the 134,000 shares then outstanding in the hands of Atlas Corporation and the public, and enabled Atlas Corporation, as Mr. Odlum expressed it, "to get his foot in the door"[1128] of Aviation Securities Corporation. Eventually, Atlas Corporation hoped to gain a profit by purchasing the remaining outstanding shares of Aviation Securities Corporation at market prices which were less than the asset value of the shares.[1129]

Although Mr. Odlum admitted that Mr. Donaldson's letter indicated that the warrants were purchased by Atlas Corporation as an inducement to the influential directors and sponsors of Aviation Securities Corporation to cause the issuance of the 20,000 shares of the treasury stock of Aviation Securities Corporation to Atlas Corporation, he testified that he did not believe that stockholders of Aviation Securities Corporation were harmed by these transactions. Nevertheless, it is obvious that transactions which might entail an eventual shift in the control and management of their company may be of substantial concern to stockholders. In addition, the entrance of Atlas Corporation into their corporation meant the commencement of a campaign by Atlas Corporation to acquire the stock of Aviation Securities Corporation for cash or by exchange offer at less than the asset value of such stock although at prices above the market prices of comparable investment company shares.

Mr. Odlum, when examined on the propriety of directors acting in transactions involving conflicting interests with their stockholders, testified:[1130]

Q. Mr. Donaldson was asking Mr. Glore, "won't you please sell us your stock below liquidating value." That is clear from his letter.

A. Yes.

Q. There, too, we have the directors in a conflicting position, Mr. Odlum. Mr. Glore is determining the price at which he will sell the treasury stock to Atlas

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[1126] Id., Commission's Exhibit No. 2001 (p. 74).

[1127] Id., Commission's Exhibit No. 1998 (Item 3).

[1128] Id., at 18075.

[1129] Id., Commission's Exhibit No. 1996. On January 27, 1931, the date that Atlas Corporation purchased from Aviation Securities Corporation 20,000 shares of that company's treasury stock, L. Boyd Hatch and John W. Donaldson, both of whom were officers of Atlas Corporation, became directors of Aviation Securities Corporation (id., at 18082 and Commission's Exhibit No. 1998 (Item 3)).

[1130] Id., at 18078–82.

Corporation, isn't that so? And yet he stands to gain or lose in a pecuniary sense dependent upon whether the sale is effected or not?

A. I think the first part of your statement is correct, that certainly in the negotiations that Donaldson carried on, he tied the purchase of the warrants in with the stock. The answer to the second part depends upon how far Glore participated in the decision to sell treasury stock * * *.

Q. Mr. Odlum, don't all of these examples present the broad problem, regardless of how honest a person may be, whether he should be permitted to place himself in a position in a transaction which affects the stockholders' rights substantially? In this case, by selling stock below asset value, he stands to lose or gain in the sense that he may be able to sell the option warrants or may not be able to sell them * * *.

A. The average individual in private life, that is in active private life, is confronted with those situations nearly every day. Naturally, it is a problem. It is a responsibility. Usually it is customary to try to guard against your own interest where there is a diversity. But I do not know how you can avoid such diversity of interest in the complicated life that the average person has to go forward with.

* * * * * * *

Q. I suppose that will have to be the job of the Commission in formulating its recommendations to Congress.

A. The Commission can't do it either. You might substitute somebody else's judgment, but if you try to do it in every case where there is a diversity of interest, there wouldn't be any private business but the Commission would be doing the private business.

Q. * * * Do you think very great harm would be occasioned to the economic foundation of this country if we were to say, "Mr. Glore, we are very sorry, but with full consciousness of your integrity and honesty, we do not think you ought to do such a thing, at least without disclosing it or without telling your stockholders that as a part of the transaction whereby the investment company is selling the Atlas Corporation securities at $132,400 below their asset value simultaneously therewith Atlas buys 43,000 of your valueless option warrants"?

A. No * * *. I do not object to the principle involved. I say that in its final working out in practical effect, there might be more harm done than savings in the few cases where it is abused.

* * * * * * *

In this particular case, I do not believe that even though they were tied together, apparently as they were, that the selling of treasury stock at or above its market value and below its liquidating value would cause such a diversity of interest as to justify imposing the judgment of some Governmental body, for example. In its final working out, it certainly did not hurt them. I don't think any of these gentlemen thought they were doing anything in the way of harm to their shareholders. Again, I am not arguing against regulation. I am merely saying that any regulation, unless the utmost care is used in defining its limits so that it is not left to judgment and personalities, will cause a lot of confusion and trouble.

Notwithstanding Mr. Odlum's testimony that Field, Glore & Co. did not desire Atlas Corporation to obtain control of Aviation Securities Corporation,[1131] Mr. Odlum, nevertheless, testified that Field, Glore & Co. continued to purchase stock of Aviation Securities Corporation in

[1131] Id., at 18074.

the market as broker for Atlas Corporation. Purchases were made by Field, Glore & Co. at bid prices fixed by Atlas Corporation.[1132]

To August 17, 1931, Atlas Corporation acquired, in addition to the 20,000 shares of Aviation Securities Corporation stock which had been acquired directly from the company itself, a total of 28,290 shares of Aviation Securities Corporation stock, bringing its total holdings to 48,290 shares at a total cost of $651,295.80.[1133] The bulk of these purchases were made through or from Field, Glore & Co. and James C. Willson & Company, two of the sponsors of Aviation Securities Corporation. In several cases purchases were made from Field, Glore & Co. at prices above the then market price of Aviation Securities Corporation stock. From June 16 to June 26, 1931, Atlas Corporation acquired from Field, Glore & Co. 8,000 shares of the stock of Aviation Securities Corporation at prices of $15 and $16 a share. The highest market price of the stock for the month of June 1931 was $13.[1134] The purchase price of these shares was approximately $21,000 in excess of their market price. On June 29, 1931, James C. Willson & Company, which was one of the sponsors of Aviation Securities Corporation and was also acting as broker in acquiring Aviation Securities Corporation stock for Atlas Corporation, sold 5,000 shares of Aviation Securities Corporation stock to Atlas Corporation at $16 a share for a total of $80,000.[1135] As has been stated above, the highest market price for the stock in the month of June 1931 was $13 a share, so that Atlas Corporation paid James C. Willson & Company approximately $15,000 in excess of the market value of the shares purchased.[1136]

On August 17, 1931, Atlas Corporation acquired control of Chatham Phoenix Allied Corporation and changed its name to Securities Allied Corporation. As an aspect of the acquisition of control of Securities Allied Corporation, the details of which have already been described,[1137] Atlas Corporation transferred to Securities Allied Corporation all of its then holdings of Aviation Securities Corporation stock—48,290 shares and 43,834 warrants—for a total consideration of $790,101.50, of which $65,751 represented the purchase price of the warrants. Since these securities had cost Atlas Corporation $782,797.80, a profit of $7,303.20 was derived by Atlas Corporation on the sale. Securities Allied Corporation charged off as worthless the warrants for which it had paid Atlas Corporation $65,751. Following this transaction Securities Allied Corporation continued to purchase additional shares of Aviation Securities Corporation stock largely through Field, Glore & Co. By December 31, 1931, Securities Allied

[1132] Id., at 18083. Mr. Odlum testified (id., at 18082–3):

Q. It was after they [John W. Donaldson and L. Boyd Hatch of Atlas Corporation] went on the Board [of Aviation Securities Corporation] that Atlas Corporation commenced its campaign to acquire more stock in the open market?

A. We authorized Field, Glore & Co. to buy all the stock they could in open market channels, and they bought it.

[1133] Id., Commission's Exhibit No. 2001, and derived from supplementary information supplied the Commission for Atlas Corporation.

[1134] Op. cit. supra, note 990, Commission's Exhibit No. 2001 (pp. 75–6).

[1135] Ibid.

[1136] Ibid.

[1137] See supra, pp. 1142–57.

Corporation held 67,571 shares, or 50.42% of the outstanding shares of the capital stock of Aviation Securities Corporation.[1138]

On June 4, 1932, Atlas Corporation, as one of 12 exchange offers made simultaneously to the stockholders of its controlled companies, offered to exchange one and two-fifths shares of its own common stock for each share of the capital stock of Aviation Securities Corporation. The offering letter stated the asset value of each share of Aviation Securities Corporation capital stock to be $12.20 a share but did not state the actual asset value of Atlas Corporation common stock,[1139] which was then $2.97 a share. However, the offering letter did state that the asset value of Atlas Corporation common stock would be $7.30 a share if all of the stockholders of Atlas Corporation's 12 subsidiary investment companies to whom exchange offers were made accepted such offers.

The one and two-fifths shares of Atlas Corporation offered for each share of the capital stock of Aviation Securities Corporation had an asset value of $4.16. The shares of Atlas Corporation offered had a market value of $7, the equivalent of the market value of each share of capital stock of Aviation Securities Corporation. However, on the basis of an asset value of $2.97 a share of Atlas Corporation common stock, acceptance of the offer by Aviation Securities Corporation stockholders would entail a gross asset loss to them per share of Aviation Securities Corporation capital stock of $8.04.[1140] On the basis of an asset value of $7.30 a share of Atlas Corporation common stock, acceptance of the offer by Aviation Securities Corporation stockholders would involve an asset loss to them per share of Aviation Securities Corporation stock of $1.98.

As a result of its June 4, 1932, offer of exchange, Atlas Corporation acquired 16,109 shares of the capital stock of Aviation Securities Corporation in exchange for 22,552.6 shares of its own common stock. On the exchange Aviation Securities Corporation stockholders who accepted the offer suffered a gross loss in asset value of $129,549 on the basis of an asset value of $2.97 for each share of the common stock of Atlas Corporation received in the exchange.[1141]

Of the 16,109 shares of Aviation Securities Corporation acquired in exchange for Atlas Corporation's common stock, 15,809 shares were transferred by Atlas Corporation to Ungerleider Financial Corporation, one of Atlas Corporation's then controlled companies, for a total consideration of $142,281, the market price of the shares.[1142] The Aviation Securities Corporation stock had cost Atlas Corporation, in

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[1138] Op. cit. supra, note 990, Commission's Exhibit No. 2001 (pp. 76–7). Mr. Odlum testified (id., at 18073–4):

> Q. You ultimately wound up with control of Aviation Securities?
> A. Yes, sir.
> Q. How did that happen?
> A. Because we went out and bought shares in the market until we got enough to take control. But that wasn't their idea.
> Q. Were they a little surprised when they found you in control?
> A. Quite disgusted.
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> * * * * * * *
>
> Q. What did they say?
> A. They wanted to keep their company going as a company * * *.

[1139] Id., Commission's Exhibit No. 1970.

[1140] Id., Commission's Exhibit No. 2001 (pp. 77–8).

[1141] Ibid. However, by becoming stockholders of Atlas Corporation, exchanging stockholders of Aviation Securities Corporation retrieved a portion of their loss in asset value.

[1142] Ibid.

terms of the asset values of the shares which it had given in exchange, approximately $66,000.[1143] The profit to Atlas Corporation on this sale to Ungerleider Financial Corporation was approximately $76,000.

On June 13, 1933, Atlas Corporation in a circular letter offered to exchange one and one-tenth shares of its common stock for each share of the stock of Aviation Securities Corporation. The letter stated the market value of Atlas Corporation common stock to be $18.50 a share.[1144] The market value of Aviation Securities Corporation stock did not appear in this letter, nor did the offer reveal the asset values of the stock of Aviation Securities Corporation or of the stock of Atlas Corporation. The asset value of the Aviation Securities Corporation stock was $17.35 [1145] a share and the asset value of one and one-tenth shares of Atlas Corporation common stock was $11.77.[1146] Consequently, an exchange on this basis entailed a gross loss in assets to each exchanging Aviation Securities Corporation stockholder of $5.58 per share of his Aviation Securities Corporation stock.[1147]

The letter stressed the active market existing for Atlas Corporation common stock.[1148] The Aviation Securities Corporation stock had been delisted by the New York Curb Exchange in January 1933.[1149]

As a result of this exchange offer, Atlas Corporation acquired 5,204 shares of Aviation Securities Corporation stock, giving in exchange therefor 50 shares of its preference stock and 5,952.9 shares of its common stock. The asset loss to Aviation Securities Corporation stockholders who accepted the offer was $24,092. By October 27, 1933, the date of the dissolution of Aviation Securities Corporation, Atlas Corporation and its controlled companies had acquired a total of 131,130 shares of its stock, equivalent to 97.85% of the 134,000 shares of the company's stock then outstanding. The total net cost of these shares (including the cost of the warrants purchased from the directors and sponsors of Aviation Securities Corporation) was approximately $1,572,000. On the dissolution of Aviation Securities Corporation, Atlas Corporation, and its controlled investment companies received as a liquidating dividend, cash and securities valued at market prices, aggregating $2,008,173.35. The profit to Atlas Corporation and its controlled companies accruing from the absorption of Aviation Securities Corporation was, therefore, approximately $436,000.[1150]

3. PURCHASE OF MANAGEMENT AND DISTRIBUTION CONTRACTS

a. To Induce Shift in Control

(1) FEDERATED CAPITAL CORPORATION—ATLAS CORPORATION

Federated Capital Corporation was incorporated in Delaware on April 7, 1927,[1151] under the auspices of William J. Thorold, who had

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[1143] Ibid.

[1144] Id., Commission's Exhibit No. 1970.

[1145] Ibid.

[1146] Id., Commission's Exhibit No. 2001 (p. 83).

[1147] Ibid. See, however, note 1141, supra.

[1148] Id., Commission's Exhibit No. 1970.

[1149] Derived from supplementary information supplied the Commission for Aviation Securities Corporation.

[1150] Op. cit. supra, note 990, Commission's Exhibit No. 2001 (pp. 84–6).

[1151] Public Examination, Federated Capital Corporation, Commission's Exhibit No. 1471.

previously been connected with investment companies in England and had sponsored several so-called "fixed investment trusts" in America.[1152]

Mr. Thorold, as president of the company from its inception until May 1931 received in salaries (including a bonus for the fiscal year ending April 30, 1929, of $50,184.45) a total of approximately $172,000.[1153]

On April 25, 1927, Federal Debenture Company, Incorporated, a company then 40% owned by Mr. Thorold, entered into a contract[1154] with Federated Capital Corporation whereby it was agreed that in consideration of the investment advice and other services to be rendered to Federated Capital Corporation by Federal Debenture Company, Incorporated, Federated Capital Corporation agreed to pay Federal Debenture Company, Incorporated, an annual fee equivalent to ½ of 1% of its total invested capital, including as capital borrowed monies. The contract was to endure for a period of five years until December 31, 1932. Under this contract Federal Debenture Company was paid $5,371 in 1928 and $24,323 in 1929.[1155] However, on February 25, 1929, the agreement was canceled and a new management contract[1156] entered into between Federated Capital Corporation and Federated Management Corporation, a company owned 90% by Mr. Thorold. The terms of this contract were similar to the original management contract with the noteworthy exception that the period of operation of the second contract was to be for 10 years, terminating on February 25, 1939. Federated Management Corportion received as management fees $31,706 in 1930 and $12,729 in 1931. The total management fees paid by Federated Capital Corporation from 1927 to May 1931 to these two companies, both substantially owned by Mr. Thorold, was $74,131.[1157]

The sales literature used in selling the stock of the company and the annual reports of the company never informed stockholders of the company of the existence of these management agreements.[1158] Without their knowledge, the stockholders became committed to the management by Mr. Thorold of their corporation, whether successful or unsuccessful, for a period of 10 years. It will be noted that compensation was based not on profits but on invested capital, a basis of compensation which would always insure a fee even if the company were unsuccessful in its operations.

The authorized capital stock of the corporation consisted of a 6% cumulative preferred stock with voting rights, each share having a par value of and entitled on liquidation of the company to a preference in assets to the extent of $25 a share, and common stock having one vote a share.[1159]

Mr. Thorold also derived profits from the distribution of the securities of Federated Capital Corporation. On April 22, 1927, Federated

[1152] Id., at 14428–9.
[1153] Id., at 14483 and Commission's Exhibit No. 1475.
[1154] Id., Commission's Exhibit No. 1474.
[1155] Id., at 14470.
[1156] Id., Commission's Exhibit No. 1495.
[1157] Id., at 14470.
[1158] Id., at 14583.
[1159] Id., Commission's Exhibit No. 1471.

Capital Corporation entered into an agreement[1160] with Federal Debenture Company, Incorporated, 40% of the stock of which was owned by Mr. Thorold, providing for the purchase by Federal Debenture Company of 9,600 shares of the company's preferred stock and 6,000 shares of its common stock for a total consideration of $360,000. In return for this commitment upon the part of Federal Debenture Company, Incorporated, Federated Capital Corporation granted to Federal Debenture Company an exclusive sales agency, until July 1933, to sell the remainder of its authorized preferred and common stock, on a 10% commission basis. Of this 10% selling commission Federal Debenture Company, Incorporated, was to retain 1%, and 9% was to be paid to dealers employed by Federal Debenture Company, Incorporated, actually to sell the securities. On February 25, 1929, this exclusive agency was canceled and a new contract entered into with Federated Management Corporation, a company 90% owned by Mr. Thorold. This new contract[1161] was similar in its provisions to the former one except that the prices to be paid by Federated Management Corporation to Federated Capital Corporation for its common stock were fixed at asset value plus 15% of such asset value.

Neither Federal Debenture Company, Incorporated, nor Federated Management Corporation actually sold the securities of Federated Capital Corporation to the public. Instead, a contract[1162] was entered into by these companies with P. H. Whiting & Co., Inc., providing for the distribution of the securities by that firm in return for a commission of 9% of the selling price of the shares to the public. A 1% commission was retained by the companies controlled by Mr. Thorold.

P. H. Whiting & Co., Inc., and its subdealers and agents engaged in an intensive sales campaign. The stock of Federated Capital Corporation was continuously offered to the public from 1927 to May 1931, when Atlas Corporation acquired control of the company. Charles H. Gleason, a vice president of P. H. Whiting & Co., Inc., testified that Federated Capital Corporation stock was virtually sold from door to door by 125 subdealers in small localities. Few shares of the stock were sold in New York City.[1163] The stock was sold in small amounts to investors who, Mr. Gleason testified, relied on their dealers for investment counsel and advice.[1164] Eventually, Federated Capital Corporation had a total of 3,300 preferred stockholders with an average of 37 shares each and 5,615 common stockholders with an average holding of 38 shares each.[1165]

In connection with and to facilitate the primary distribution of the stock, P. H. Whiting & Co., Inc., maintained an over-the-counter market for the company's securities and continued to do so until Atlas Corporation acquired control of the corporation.[1166] Mr. Thorold's Federated Management Corporation also engaged in market-support-

[1160] Id., Commission's Exhibit No. 1472.

[1161] Id., Commission's Exhibit No. 1495.

[1162] Id., Commission's Exhibit No. 1473.

[1163] Public Examination, Atlas Corporation, Commission's Exhibit No. 1982; op. cit. supra, note 1151, at 14570–1.

[1164] Op. cit. supra, note 1151, at 14571.

[1165] Public Examination, Atlas Corporation, Commission's Exhibit No. 1982.

[1166] Op. cit. supra, note 1151, at 14566, 14568.

ing operations in Federated Capital Corporation's stock, particularly after the market collapse of October 1929.[1167]

To May 1931, a total of 122,320 shares of the preferred stock and 218,399 shares of the common stock of Federated Capital Corporation were sold to the public by P. H. Whiting & Co., Inc., and its subdealers. On these sales the corporation received a total of $6,122,680.37. The total selling commissions were $310,291.52, of which 1%, or $31,029, was retained by Mr. Thorold's companies, Federal Debenture Company, Incorporated, and Federated Management Corporation, and the remainder was retained by P. H. Whiting & Co., Inc., and its subdealers.[1168]

From the inception of the company to May 1931, when control of the company passed to Atlas Corporation, the company paid out as dividends $378,966.38. Treating these dividends as a return of capital, the net capital contributed to the enterprise was $5,743,713.99.[1169]

The company, under Mr. Thorold's management, widely diversified its security investments.[1170] The company, however, did not in general hold securities for investment purposes but rather actively traded in securities. The extent of this trading activity is indicated by the fact that, in the four years during which the company was managed by Mr. Thorold, it purchased and sold approximately $53,000,000 worth of securities.[1171] In other words, the company's capital of approximately $6,000,000 was turned over approximately nine times. In addition, the company's capital was augmented by borrowed monies. On October 17, 1929, the company borrowed $900,000,[1172] which was immediately invested in securities which substantially depreciated in value following the stock market collapse of October 29, 1929. However, borrowing money was advantageous to Mr. Thorold since his controlled companies, Federal Debenture Company, Incorporated, and Federated Management Corporation received as management compensation from Federated Capital Corporation ½ of 1% of all borrowed monies in addition to the ½ of 1% on the company's capital invested by its stockholders.

By May 1931, the corporation's assets had depreciated to $2,845,008.31. In other words, the company on its operations had suffered losses, realized and unrealized, of $2,898,705.68. This loss was approximately 50% of the net capital of $5,743,713.99 contributed to the corporation by its stockholders.[1173]

The asset value of the company's preferred stock in May 1931 was $24.48 a share, which was less than the $25 a share par value of the stock to which it was entitled on dissolution. The market value of the stock was $14.37 a share, or approximately $10 a share less than its asset value. The common stock had no asset value but had a market value of approximately 62 cents a share.[1174]

[1167] Id., at 14592.

[1168] Id., Commission's Exhibit No. 1476.

[1169] Op. cit. supra, note 1165, Commission's Exhibit No. 2003.

[1170] Op. cit. supra, note 1151, at 14521. At their peak the funds of Federated Capital Corporation were invested in 270 securities (ibid.).

[1171] Id., at 14474.

[1172] Id., at 14473.

[1173] Op. cit. supra, note 1165, Commission's Exhibit No. 2003.

[1174] Id., Commission's Exhibit No. 2001 (pp. 222–4).

In contrast to these losses suffered by the company's stockholders, William J. Thorold and his controlled companies, Federal Debenture Company, Incorporated, and Federated Management Corporation, received in salaries, selling commissions, and management fees a total of $286,327.73.

Following the market collapse of 1929, it became exceedingly difficult to sell additional shares of Federated Capital Corporation securities. P. H. Whiting & Co., Inc., and its subdealers, principally Williams, Partridge and Rapley of Montreal, Canada, who had sold a large number of the company's securities in Canada, became dissatisfied with the management of Federated Capital Corporation.[1175] They demanded that nominees of the dealers be elected to the board of directors of Federated Capital Corporation, so that the dealers might acquire exact information as to the affairs of the company.[1176] Mr. Thorold, however, refused to accede to this request.[1177]

P. H. Whiting & Co., Inc., also objected to the high ratio of the company's operating expenses to its total assets.[1178] Fully 59% of the total expenses of the company consisted of Mr. Thorold's salary and the management fees paid to his controlled companies.[1179] This pressure brought by the dealers upon Mr. Thorold apparently induced him to waive his salary for the year ending April 30, 1931. However, when Atlas Corporation acquired control of Federated Capital Corporation, as part of the transaction for acquisition of control of Federated Capital Corporation, Atlas Corporation paid Mr. Thorold his salary ($27,000) for the year ending April 30, 1931.[1180]

In June 1930, Matthew Robinson, an employee of Atlas Corporation's subsidiary, All America General Corporation, approached P. H. Whiting & Co., Inc., to inquire as to the possibility of the acquisition by Atlas Corporation of control of Federated Capital Corporation.[1181] P. H. Whiting & Co., Inc., held no stock in Federated Capital Corporation.[1182] However, P. H. Whiting & Co., Inc., as the distributor of Federated Capital Corporation's securities[1183] would be invaluable in procuring purchases and exchanges of Federated Capital Corporation's securities for Atlas Corporation. In other words, the confidence of the Federated Capital Corporation security holders in P. H. Whiting & Co., Inc., and its subdealers, who had sold them the securities, would enable P. H. Whiting & Co., Inc., and its dealers to reverse, in effect, the original process of distribution of the shares and to reacquire them for the account of Atlas Corporation.

The negotiations between Atlas Corporation and P. H. Whiting & Co., Inc., did not materialize into an agreement until January 1931, primarily because of the fact that Federated Capital Corporation was still paying dividends on its preferred and common stock.[1184] Apparently, it would have been difficult to persuade holders of divi-

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[1175] Op. cit. supra, note 1151, at 14551.

[1176] Id., at 14549.

[1177] Id., at 14578.

[1178] Op. cit. supra, note 1165, at 17946.

[1179] Op. cit. supra, note 1151, at 14544–5.

[1180] Id., at 14606.

[1181] Op. cit. supra, note 1165, Commission's Exhibit No. 1982.

[1182] Id., at 17945.

[1183] Id., at 17943.

[1184] Id., Commission's Exhibit No. 1982.

dend paying securities to sell or exchange their stock. However, in January 1931, Federated Capital Corporation ceased to pay dividends on its securities.[1185]

On January 28, 1931, Atlas Corporation and P. H. Whiting & Co., Inc., reached an agreement,[1186] the salient provisions of which were as follows:

> We [P. H. Whiting & Co., Inc.] shall * * * endeavor to buy for you in the market, subject at all times to your [Atlas Corporation] direction, such quantities of the preferred and/or common stock of Federated Capital Corporation as you may desire to purchase.
>
> We also agree to use our best efforts towards getting stockholders to exchange their shares for shares of Atlas Corporation, as such time as you are in a position to make a satisfactory exchange offer to Federated stockholders.
>
> As compensation for our services and to cover such expenditures as we shall, no doubt, have to make, including a probable payment to dealers for their assistance in obtaining proxies and/or exchanges of stock, we are to be paid $1.00 per share for each share of preferred and $.20 per share for each share of common stock of Federated Capital Corporation, which is either exchanged for stock of Atlas Utilities Corporation, whether such exchanges or purchases be made through P. H. Whiting & Co., Inc., or by other means.
>
> * * * * * * *
>
> On call for a meeting of stockholders of Federated Capital Corporation, P. H. Whiting & Co., Inc., is to receive $.50 per share on all preferred stock and $.10 per share on all common stock on which proxies are obtained by or for you. We appreciate that the above payment must be predicated upon the acquiring of a definite minimum number of shares of stock necessary to accomplish the purpose of the meeting. * * *

Atlas Corporation thus acquired for a consideration the support and prestige of P. H. Whiting & Co., Inc., and its subdealers in its campaign to acquire the securities of Federated Capital Corporation. P. H. Whiting & Co., Inc., which had sold the company's securities to the public and which concededly owed the security holders at least a moral obligation to protect them from further losses,[1187] was committed to solicit acceptance of future "satisfactory" exchange offers.

Having thus acquired the cooperation of the distributors of the company's securities, Atlas Corporation's next step was to acquire control of the management of the portfolio of Federated Capital Corporation. Such control was necessary to protect the asset gains which Atlas Corporation would realize from purchases and exchanges of Federated Capital Corporation's securities for a consideration less than the asset values of such securities. It was also necessary to avoid the possibility of opposition to Atlas Corporation's program by Mr. Thorold.

As has been pointed out, Federated Management Corporation, a company controlled by Mr. Thorold, held a contract to manage the portfolio of Federated Capital Corporation until February 1939. To acquire control of the management, it was necessary for Atlas Corporation to acquire the management contract held by Federated

[1185] Op. cit. supra, note 1151, Commission's Exhibit No. 1485.
[1186] Op. cit. supra, note 1165, Commission's Exhibit No. 1982.
[1187] Id., at 17946.

Management Corporation. The latter corporation also owned 8,000 shares of the preferred stock of Federated Capital Corporation.

Mr. Thorold had meanwhile been conducting negotiations of his own with representatives of several other investment companies who were desirous of acquiring control of Federated Capital Corporation. Among the investment companies which had negotiated with Mr. Thorold were International Utilities Corporation, Transamerica Corporation, Tri-Continental Corporation, and Phoenix Securities Corporation. Harold A. Fortington, the American representative of the Royal Insurance Company of England, also had discussions with Mr. Thorold relative to acquiring control of Federated Capital Corporation.[1188] Mr. Thorold had been offered as much as $160,000 by these corporations and individuals for an assignment to them of the management contract held by his Federated Management Corporation.[1189]

However, considerable influence was exerted upon Mr. Thorold by P. H. Whiting & Co., Inc., and its associated dealers to enter into an agreement shifting the management of Federated Capital Corporation to Atlas Corporation. Mr. Thorold testified:[1190]

A. * * * a number of the stockholders and their representatives wanted it turned over to them [Atlas] and they came to us, saying that they represented a very, very large proportion of the stockholders and they favored turning it over to Atlas.

Q. Will you tell us the names of these representatives of large stockholders?

A. I think that there was more particularly representatives of Williams, Partridge & Rapley of Montreal.

Q. You say that they wanted you to turn over control of this trust to Atlas Corporation?

A. Well, I wouldn't like to specifically state that, but I think they did. In any event, about that time, considerable influence was brought to bear on me to do so and I think P. H. Whiting & Co., Inc., also. They represented a large number of stockholders.

Q. And then you say P. H. Whiting & Co., Inc., was exerting pressure upon you to have you transfer control of this trust to Atlas Corporation?

A. Well, I said that they were exerting influence and I didn't say pressure.

P. H. Whiting & Co., Inc., did not reveal to Mr. Thorold the arrangement which it had entered into with Atlas Corporation in January 1931.[1191]

As a result of the influence brought to bear upon Mr. Thorold, Atlas Corporation, on May 12, 1931, entered into an agreement with Federated Management Corporation, Mr. Thorold's company, whereby Atlas Corporation was assigned the management contract held by Federated Management Corporation. As consideration for this assignment Atlas Corporation paid Federated Management Corporation the sum of $85,000.

In addition, Atlas Corporation purchased the 8,000 shares of Federated Capital Corporation preferred stock owned by Federated Management Corporation at $20 a share, a price approximately $6 in excess of the market value of the shares, but approximately $4.50 less

[1188] Id., Commission's Exhibit No. 2001.
[1189] Ibid.
[1190] Op. cit. supra, note 1151, at 14587.
[1191] Id., at 14588.

than the asset value of such shares. Mr. Thorold's Federated Management Corporation, on this sale, was thereby paid approximately $48,000 in excess of the market value of its holdings of Federated Capital Corporation preferred stock. Atlas Corporation also agreed to purchase and did purchase at $20 a share, 5,000 shares of Federated Capital Corporation preferred stock, owned by directors of Federated Capital Corporation, principally David Bandler and Colonel John H. Price. Atlas Corporation paid to these directors approximately $30,000 above the market price of their stock.[1192]

The agreement between Federated Management Corporation and Atlas Corporation also provided that "it is the good faith and understanding of the parties hereto that there shall be no further purchases in the market of stock in Federated Capital Corporation by Federated Management Corporation or by W. J. Thorold, except for the account of Atlas Corporation with its previous consent." This agreement, in effect, required Mr. Thorold and Federated Management Corporation to cease their market-supporting operations in the securities of Federated Capital Corporation, thereby insuring to Atlas Corporation complete control of the market in the corporation's securities.[1193]

On May 12, 1931, Atlas Corporation entered into an agreement with Federated Capital Corporation to manage its portfolio, supply it with clerical and bookkeeping services, and to provide it with office space, for an annual fee equal to ½ of 1% of the assets of the corporation. Atlas Corporation also purchased from Federated Capital Corporation 31,600 shares of its common stock at the price of $1 a share. This stock, as has been pointed out, had no asset value.[1194]

This management contract with Atlas Corporation was approved by the board of directors of Federated Capital Corporation on May 14, 1931. Mr. Thorold, in presenting the contract to the directors for their approval, stated that the difficulties of Federated Capital Corporation were in large part due to the fact that the ratio of its operating expenses to its capital was inordinately large. He stated to the board that "it was generally recognized that it would cost little or no more to manage and domicile a company of $30,000,000 capital [the then value of Atlas Corporation assets] than one of $3,000,000."[1195] The chief advantage of the contract with Atlas Corporation was the fact that all the expenses of the company, including salaries, would be covered by the ½ of 1% management fee, payable to Atlas Corporation. In other words, the savings which would result to Federated Capital Corporation were principally to be effected by the elimination of the salary previously paid by the company to Mr. Thorold.

On May 15, 1931, all of the directors, with the exception of Mr. Thorold, resigned and Atlas Corporation placed its nominees upon the board of directors of Federated Capital Corporation.

Having completed this series of negotiations, Atlas Corporation was in a position to foster its program of acquisition of the securities of Federated Capital Corporation. Atlas Corporation was the only

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[1192] Id., Commission's Exhibit No. 1494, and derived from supplementary information supplied the Commission for Federated Capital Corporation.

[1193] Op. cit. supra, note 1151, Commission's Exhibit No. 1494.

[1194] Op. cit. supra, note 1165, Commission's Exhibit No. 2001 (pp. 222–4).

[1195] Ibid.

substantial buyer of, and therefore in a position to control the market in, Federated Capital Corporation's securities. After reaching its agreement with Atlas Corporation, P. H. Whiting & Co., Inc., ceased to support the over-the-counter market in the securities of Federated Capital Corporation. Charles H. Gleason, a vice president of P. H. Whiting & Co., Inc., testified:[1196]

Q. Now, you kept * * * sponsoring the market in that stock throughout this entire period?

A. From 1927 until we finally withdrew some time in 1931.

Q. That is in 1931 when you made the arrangement with Atlas Corporation?

A. When Atlas took it over, and we had to—and we were sponsoring it.

Q. You felt that you owed it to the stockholders that they have some kind of respectable market; isn't that so?

A. Our dealers are our stock in trade, the same as the investor is the dealer's stock in trade; and if we wanted to do any business, we had to do the very best we could in maintaining secondary markets on what we sold.

Q. In that connection, Mr. Gleason, I think that it is elementary that if you hadn't been in there policing the market in connection with the secondary distribution you probably would have had a worse market; isn't that so?

A. I am absolutely convinced that if I hadn't been in there helping to support this market, and in turn getting our own sales organization and dealers to distribute, the market would have gone right down like that, because there would have been nobody supporting it if I hadn't been; and the stockholders that had stock, some of them actually needed their money, that I know; and if I had not been in there supporting that market, those people would have got zero for their stock, because there had been nobody supporting the market.

* * * * * * *

Q. Mr. Gleason, I think you told us that you made some arrangement with the Atlas Corporation with respect to acquiring stock for them on a fixed commission; isn't that so?

A. Yes.

* * * * * * *

Q. But you did have some arrangement with them that you would pick up the stock for them and you would get a commission?

A. We would take whatever stock they wanted to buy and handle it and get a commission from the buyer; yes.

Q. And as soon as you made that arrangement you stopped supporting the market; isn't that so?

A. As soon as we made that arrangement, naturally, we were buying for them, and we had to buy at their price; that is true.

Q. And necessarily, if you were buying for them, you would have to try to get it at the cheapest price for them; isn't that so?

A. Well, no. My recollection is that when I started buying for them they didn't try to chisel down on that market. They started taking the stock at whatever the market was, and I think you will find as time went on they had to keep paying more for that stock.

Q. But you withdrew your support; isn't that so?

A. Well, naturally, if I am going to buy for the—I was through. In other words, the trust had been taken over by them. There was no more stock to be sold.

Q. There would have been a conflict. If you were supporting the market and buying for them, it means——

[1196] Op. cit. supra, note 1151, at 14563 and 14610.

A. I have either got to serve one master or the other.

Q. And in this case you were serving—who was your master?

A. I was serving Atlas. That is, after they took control, we were entirely through with Federated. Then I bought stock for them.

Q. So that the Atlas Corporation was your master from that point on?

A. True; I had to buy it.

The arrangement between Mr. Thorold and Atlas Corporation, as has been pointed out, required Mr. Thorold to terminate his and Federated Management Corporation's market-supporting operations in the securities of Federated Capital Corporation.

Mr. Thorold testified:[1197]

A. We [Federated Management Corporation and Mr. Thorold] had been buying stock in support of the market but after a while we couldn't buy it all * * * after that agreement [with Atlas] we never bought any.

Q. And I know that, but you never bought any because there was a provision that it was your good faith and your representation that you wouldn't buy any?

A. Yes, sir.

Q. And, of course, withdrawing your support from the market, of course, didn't help the market price any; did it?

A. No; I suppose it did not.

The stockholders of Federated Capital Corporation were never informed of the arrangement between P. H. Whiting & Co., Inc., and Atlas Corporation. Nor were they informed of the transaction which shifted control of the management to Atlas Corporation. Thus, Mr. Thorold testified:[1198]

Q. Now, you never wrote to the stockholders telling them that you were going to assign this contract?

A. No.

Q. And the fact is that when the assignment took place you didn't write to the stockholders telling them that there was a new fiscal agent, who was going to give the investment advice; did you?

A. I don't think so.

Q. And necessarily, since the stockholders weren't informed or apprised of the fact that the assignment took place, you certainly didn't ask their permission or consent; isn't that so?

A. That is so.

* * * * * * *

Q. And this entailed the fact that you who had sponsored this corporation, and were responsible for its creation, were stepping out of the picture?

A. Yes, sir.

Mr. Thorold also testified:[1199]

Q. Well, did you tell the stockholders that "the Atlas Corporation is paying me $20 a share for my stock and my friends $20 a share for the preferred and I am going to see that you are going to get $20 too"?

A. No. I was entitled to sell my shares at any price I liked.

* * * * * * *

[1197] Id., at 14592.
[1198] Id., at 14585.
[1199] Id., at 14604–5.

Q. You were firmly convinced that Atlas Corporation would do a better job than you; isn't that so?

A. Yes.

Q. You didn't offer to cancel your contract and say, "Mr. Odlum, come in here and take charge of this. I think I owe it to my stockholders who by virtue of my management sustained a loss of two and a half million dollars"?

A. No; because Mr. Odlum said, "Here is so much money for ——"

Q. His $85,000?

A. His $85,000, and if I would sell the contract at $85,000 and get a better manager for the stockholders, I was doing something that was in the interest of the stockholder.

The $85,000 received by Mr. Thorold for his company's management contract with Federated Capital Corporation increased the total profits derived by him and his companies, from his association with Federated Capital Corporation, to $371,327.73.[1200] In addition, his company, Federated Management Corporation, also succeeded in selling 8,000 shares of preferred stock to Atlas Corporation at a price $48,000 in excess of its market price.[1201] The record does not indicate Mr. Thorold's position with respect to the Atlas Corporation's exchange offers for the stock of Federated Capital Corporation made in 1932 and 1933.

P. H. Whiting & Co., Inc., received gross selling commissions on its distribution of Federated Capital Corporation's securities of $319,972.31.[1202] It received as gross commissions from Atlas Corporation for its aid in purchasing Federated Capital Corporation's securities for the account of Atlas Corporation and for its solicitation of acceptance of Atlas Corporation's exchange offers, a total of approximately $160,000.[1203]

With respect to the stockholders of Federated Capital Corporation, P. H. Whiting & Co., Inc., and its securities dealers, in whom the stockholders presumably had confidence, had an undisclosed pecuniary interest in advocating acceptance of Atlas Corporation's exchange offers or the sale of their stock to Atlas Corporation. The management of their corporation was in the hands of Atlas Corporation. Their former directors had ceased to have any further pecuniary interest in the corporation's affairs. Several of these directors' shares had been purchased at an attractive price by Atlas Corporation.

Although Atlas Corporation was managing the corporation's portfolio, the differential between the asset and market value of the corporation's preferred stock was never eliminated. Between 1931 and 1933, the years in which Atlas Corporation acquired most of its holdings of the corporation's preferred stock, the difference between the asset value of the preferred stock and its market value was substantial. The following schedule[1204] indicates the extent of the discrepancy between the asset value and the market price of the preferred stock of Federated Capital Corporation during the period of its management by Atlas Corporation.

[1201] See supra, p. 1282.

[1201] Op. cit. supra, note 1165, Commission's Exhibit No. 2001 (p. 223).

[1202] Op. cit. supra, note 1151, Commission's Exhibit No. 1475.

[1203] Op. cit. supra, note 1151, at 17950.

[1204] The figures in the table are derived from the annual reports of Federated Capital Corporation, contained in Pt. I of the reply to the Commission's questionnaire for Federated Capital Corporation and from the *Bank and Quotation Record.*

Date	Asset value per share	Market value during specified month	
		High	Low
Apr. 30, 1931	$24.48	$14⅜	([a])
Dec. 31, 1931	18.93	16	$10
Dec. 31, 1932	17.92	12	([a])
Dec. 31, 1933	23.02	14	9¾
Dec. 31, 1934	22.15	17	13½
Dec. 31, 1935	25.57	23½	15

[a] Price not available.

It is to be remembered that Atlas Corporation, as a result of its arrangement with P. H. Whiting & Co., Inc., was in a position to control the market price of the stocks of Federated Capital Corporation. However, the price actually paid by Atlas Corporation for the securities of Federated Capital Corporation exceeded the market value of comparable investment company securities.

The profits to be made by Atlas Corporation on its acquisition consisted of these spreads between the asset value and the price paid by Atlas Corporation for the preferred stock. The common stock had no asset value but, throughout the period of Atlas Corporation's control of Federated Capital Corporation, the common stock had a market value of approximately $1 a share. Atlas Corporation had to purchase this common stock since it was necessary for Atlas Corporation to acquire at least 66⅔% of all classes of voting stock in order to enable it to dissolve the corporation and so realize its profits on the preferred stock.

Immediately upon the conclusion of the agreement between Atlas Corporation and P. H. Whiting & Co., Inc., the latter commenced to bid for Federated Capital Corporation's securities at prices fixed by Atlas Corporation.[1205] Dealers throughout the United States and Canada were sent letters quoting the prices offered by Atlas Corporation for the securities.

In addition to the 13,000 shares of Federated Capital Corporation preferred stock purchased by Atlas Corporation from Federated Management Corporation and the directors of Federated Capital Corporation, already named, Atlas Corporation in 1931 purchased, through P. H. Whiting & Co., Inc., a total of 9,826 shares of Federated Capital Corporation preferred stock at a cost of $151,948.16.[1206] A total of 22,826 shares of Federated Capital Corporation preferred shares were acquired by Atlas Corporation in 1931 at a total cost, including $16,000 commissions paid to P. H. Whiting & Co., Inc., and the $85,000 paid for the management contract of Federated Management Corporation, of $513,465.16.[1207] In addition, Atlas Corporation held 31,600 shares of the common stock of Federated Capital

[1205] Op. cit. supra, note 1165, at 17957.
[1206] Id., Commission's Exhibit No. 2001 (p. 225).
[1207] Ibid.

Corporation, which, as has been indicated, it had purchased from that company at a cost of $31,600.

However, during the year 1931 Atlas Corporation disposed of all its holdings of Federated Capital Corporation securities to its controlled companies. Of its holdings of the Federated Capital Corporation preferred stock, 19,000 shares were sold to Iroquois Share Corporation for $277,494 (the market value)[1208] at a book loss to Atlas Corporation of $172,416.27. On August 17, 1931, Iroquois Share Corporation sold all of its assets to Chatham Phenix Allied Corporation, control of which was acquired by Atlas Corporation on the same day.[1209] Iroquois Share Corporation was then immediately dissolved, and the cash it had received from the sale of its assets to Chatham Phenix Allied Corporation was transferred to Atlas Corporation as a liquidating dividend.[1210] As has been indicated in the discussion of the acquisition of control of Chatham Phenix Allied Corporation by Atlas Corporation, the cash derived by Atlas Corporation on the liquidation of Iroquois Share Corporation was used by Atlas Corporation to pay in part a bank loan incurred by Atlas Corporation to obtain the funds which were used by Atlas Corporation to acquire control of Chatham Phenix Allied Corporation.[1211] Among the assets transferred by Iroquois Share Corporation to Chatham Phenix Allied Corporation were the 19,000 shares of Federated Capital Corporation preferred stock which Iroquois Share Corporation had acquired from Atlas Corporation at a cost of $277,494. Iroquois Share Corporation received from Chatham Phenix Allied Corporation $304,000 (the market value) for these shares. Iroquois Share Corporation, therefore, realized a profit of $26,506 on the sale.[1212]

On August 17, 1931, the day on which Atlas Corporation acquired control of Chatham Phenix Allied Corporation, the latter purchased for $63,200 from Atlas Corporation the 31,600 shares of common stock of Federated Capital Corporation then held by Atlas Corporation.[1213] Since these shares had cost Atlas Corporation $31,600,[1214] Atlas Corporation on this sale to its newly acquired company derived a profit of $31,600. These shares were sold to Chatham Phenix Corporation at a price of $2 a share. These shares, as has been pointed out, had no asset value. The market price of the stock, in August 1931, was $1⅝ with only 100 shares being traded over-the-counter during the month.[1215]

Atlas Corporation, on August 17, 1931, also sold to Chatham Phenix Allied Corporation 2,039 shares of Federated Capital Corporation preferred stock for $32,624 (the market price).[1216] Thereafter, Atlas Corporation sold an additional 1,687 shares of Federated Capital Corporation preferred stock to Chatham Phenix Allied Corporation for $26,992.[1217] On these sales of preferred stock, Atlas Corporation suffered a book loss of $3,662.89.

[1208] Id., Commission's Exhibit No. 2001 (p. 226).
[1209] Ibid.
[1210] Ibid.
[1211] See supra, pp. 1149–51.
[1212] Op. cit. supra, note 1165, Commission's Exhibit No. 2001 (p. 97).
[1213] Ibid.
[1214] See supra.
[1215] *Bank and Quotation Record,* September 1931.
[1216] Op. cit. supra, note 1165, Commission's Exhibit No. 2001 (p. 226).
[1217] Ibid.

As a result of these transactions, the entire position of Atlas Corporation in Federated Capital Corporation's securities was transferred to Chatham Phenix Allied Corporation, whose name, on its becoming a subsidiary of Atlas Corporation, was changed to Securities Allied Corporation. Thereafter until its dissolution in December 1933, Securities Allied Corporation became the purchaser of nearly all of the securities of Federated Capital Corporation, acquired in the market through P. H. Whiting & Co., Inc.

The first exchange offer made by Atlas Corporation for the securities of Federated Capital Corporation occurred on June 4, 1932, and was one of 12 simultaneous exchange offers made to stockholders of investment companies controlled by Atlas Corporation. Atlas Corporation offered to exchange four-tenths of one of its option warrants for each share of the common stock of Federated Capital Corporation, and a unit consisting of one-sixth of a share of Atlas Corporation's preference stock, one-half of a share of its common stock, and three-quarters of one of its warrants for each share of the preferred stock of Federated Capital Corporation.

The Federated Capital Corporation common stock had no asset value but had a market value of 50 cents a share. The four-tenths of an Atlas Corporation warrant offered for this stock had a market value of approximately 45 cents.[1218]

The offering letter revealed the fact that the asset value of the Federated Capital Corporation preferred stock was approximately $15.75 a share. Not revealed, however, was the fact that the unit of Atlas Corporation's securities offered for the stock then had an aggregate asset value of $9.81. Acceptance of the offer by preferred stockholders thus resulted in a gross loss in asset values per share of their stock of $5.94. However, the market value of the Atlas Corporation unit of securities offered for the Federated Capital Corporation preferred stock was $9 as compared with the then market price of Federated Capital Corporation preferred stock of $8 a share.[1219]

The June 4, 1932, offer was represented to be "limited for a short period of time," but was extended from June 25, 1932, to July 15, 1932, and in addition, on September 23, 1932, the offer was renewed.[1220]

As a result of the offer, Atlas Corporation acquired a total of 33,392 shares of the preferred stock and 89,947 shares of the common stock of Federated Capital Corporation. On the exchanges, accepting Federated Capital Corporation preferred stockholders suffered a gross loss in asset values of $253,589.[1221]

Acceptance of this exchange offer was actively solicited by P. H. Whiting & Co., Inc., and its subdealers.

On June 13, 1933, Atlas Corporation made a second exchange offer of its securities for the securities of Federated Capital Corpora-

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[1218] Id., Commission's Exhibits Nos. 1970, 2001 (pp. 228–30).

[1219] Id., Commission's Exhibit No. 2001 (pp. 229–30). The asset value of Atlas Corporation common stock on June 4, 1932, was $2.97 a share, but the offering letters stated that if all of the stockholders of Atlas Corporation's subsidiaries accepted its exchange offer, the asset value of such stock would be $7.30 a share.

[1220] Id., Commission's Exhibit No. 1970.

[1221] Id., Commission's Exhibit No. 2001 (p. 231). However, by becoming stockholders of Atlas Corporation, exchanging Federated Capital Corporation preferred stockholders recovered a portion of their losses in asset value.

tion.[1222] For each share of Federated Capital Corporation preferred stock, Atlas Corporation offered one share of its own common stock; for each share of the common stock of Federated Capital Corporation, Atlas Corporation offered a warrant to purchase three-tenths of a share of its common stock at any time at a price of $25 for the full share of Atlas Corporation common stock. The market value of this fraction of one of its warrants offered by Atlas Corporation was approximately equivalent to the market value of the Federated Capital Corporation common stock, which had no asset value. The offering letter did not refer to the asset value of the securities to be exchanged but pointed out the superior marketability of the Atlas Corporation shares. The market value of the Atlas Corporation common stock was $18.50 a share, as contrasted with the then market price of $10 a share for Federated Capital Corporation preferred stock. On the basis of market values, Federated Capital Corporation's preferred stockholders exchanging their shares would derive a gain of $8.50 a share.[1223] However, the asset value of each share of Federated Capital Corporation preferred stock was then $21.79, as contrasted with the asset value of $10.70 a share then existing for each share of Atlas Corporation common stock. An exchanging Federated Capital Corporation preferred stockholder, therefore, suffered a gross loss in assets for each share of his preferred stock of $11.09.[1224] Exchanges under this offer were also actively solicited by P. H. Whiting & Co., Inc., and its subdealers throughout the United States and Canada.

As a result of this offer, Atlas Corporation acquired 4,104 shares of Federated Capital Corporation preferred stock and 14,454 shares of Federated Capital Corporation common stock. The gross loss in asset values to Federated Capital Corporation stockholders who accepted the offer was $38,488.41.[1225]

On July 25, 1935, Atlas Corporation voted its shares of Federated Capital Corporation in favor of the dissolution of the Corporation. Atlas Corporation then controlled 172,985 shares of Federated Capital Corporation common stock, or 68.6% of the total of such stock outstanding, and 115,453 shares of Federated Capital Corporation preferred stock, or 94.2% of the total of such shares then outstanding.[1226]

The total book cost of the investment by Atlas Corporation and its subsidiaries in the securities of Federated Capital Corporation was $1,960,537.10,[1227] before deducting the asset gains which it had derived as the result of its exchange offers. After deducting these gains the net cost of the investment was $1,668,459.69.

On the dissolution of Federated Capital Corporation, Atlas Corporation received, as a liquidating dividend, cash and securities at market value totaling $2,886,325. From this sum $96,201.25 was released to Federated Capital Corporation to enable it to pay the minority common stockholders $1.25 a share.[1228] The net proceeds of the investment in Federated Capital Corporation by Atlas Corpora-

[1222] Id., Commission's Exhibits Nos. 1970, 2001 (p. 232).
[1223] Id., Commission's Exhibit No. 2001 (pp. 233–4).
[1224] Ibid.
[1225] Ibid. See, however, note 1221, supra.
[1226] Ibid.
[1227] Ibid.
[1228] Ibid. See infra, pp. 1440–2.

tion were, therefore, $2,789,724, and the profit derived by Atlas Corporation on its investment in the securities of Federated Capital Corporation was approximately $1,121,000. Although to a large extent this profit represents an appreciation in the asset value of the preferred stock of Federated Capital Corporation after acquisition by Atlas Corporation, a substantial part of this profit was made on purchases of and exchanges for the preferred and common stock of Federated Capital Corporation at prices less than the asset values of the preferred stock of Federated Capital Corporation.

(2) OILS & INDUSTRIES, INC. (FORMERLY KNOWN AS OIL SHARES INCORPORATED)—WATSON, ET AL.

Oils & Industries, Inc.,[1229] was organized as Oil Shares Incorporated in 1928, and approximately $13,200,000 was paid by investors for units of its preferred and common stock.

Until October 1931, the investment company was sponsored and controlled by Pettigrew and Meyer, Inc., although this fact was not specifically disclosed to the stockholders. Prior to the public sale of the investment company's stock, a wholly-owned corporation of Pettigrew and Meyer, Inc., obtained a contract to manage the investment company for a term of nine years at a monthly fee of 1/24 of 1% of the investment company's net assets, plus 20% of the profits in excess of $1.50 a share on the common stock.

Early in 1930, because no market for its stock existed, the investment company amended its charter to permit redemption of its stock in 500-unit lots at 91% of their asset value and agreed, without knowledge of the stockholders, to pay the sponsor the remaining 9% of the asset value of redeemed shares.

By September 1931 the pecuniary emoluments accruing to the sponsor from its association with the investment company amounted to $674,700. In contrast, by September 1931, the investment company, after returning to its stockholders by way of dividends, and redemption of its own securities, $7,104,000 of the $13,200,000 originally contributed by the stockholders, had net assets of $1,200,000 as compared with the net contribution of $6,096,000 made to the corporation by its stockholders. In other words, the stockholders had suffered a loss of $4,896,000 or 80% of their net investment in the enterprise.

Because of the redemption privilege accorded to the company's stockholders after April 8, 1930, the company's assets began to diminish rapidly as stockholders exercised their right of withdrawal. As Mr. Meyer, one of the sponsors, asserted, the trust "was drying up."[1230] Compensation under the management contract held by Petroleum Research Corporation, the wholly-owned corporation of Pettigrew and Meyer, Inc., became steadily smaller. Petroleum Research Corporation had received as management compensation in 1928, $30,378: in 1929, $59,052.62; in 1930, $39,520.71. In 1931, the corporation received $13,594.17 as management fees. By September 1931, the assets of Oils & Industries, Inc., as has been stated, totaled

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[1229] For a detailed discussion of the history of Oils & Industries, Inc., containing appropriate references to the record, see Ch. II of this part of the report, pp. 94–114.

[1230] Public Examination, Oils & Industries, Inc., at 14142.

$1,200,000, which indicated a management fee of only $6,000 for 1932. The possibility of an immediate substantial rise in the value of the assets of the investment company at that time seemed remote.

In October 1931, when the management fees had diminished, as a result of the "drying up" of the trust caused by the redemption of its stock, and of the decline in value of the trust's portfolio, the sponsor, without informing the stockholders, agreed to sell its management contract for $145,000 to Holman, Rapp & Company, a Philadelphia investment banking firm, which also agreed to purchase from the investment company 10,000 units of its securities for $167,000.

Holman, Rapp & Company was acting on behalf of Thomas Watson, Joseph Herzberg, and Montifiore Kahn, who did not possess the funds to fulfill the obligations which Holman, Rapp & Company had contracted on their behalf. This group, by representing that it was to acquire control of Oils & Industries, Inc., succeeded in inducing a bank to lend the investment company $177,000, to be repaid as soon as control was obtained. This group arranged the closing of the contracts with the sponsor and the investment company in the offices of the bank, where an official of the bank exhibited a cashier's check for $167,000, payable to the investment company for the 10,000 units, and delivered to the sponsor a cashier's check for $10,000 as part payment for the management contract. The check for $167,000 was deposited for the account of the investment company with the bank, which immediately applied it to the reduction of the loan of $177,000.

The existing board of directors of the investment company, all of whom had been selected by the sponsor, resigned and were replaced by nominees of the Watson group. Once in control, this group liquidated the portfolio of the investment company and used the proceeds to satisfy the balance of the bank's loan of $10,000 and pay the sponsor $135,000 still due on the purchase price of the management contract. Within a short time after acquisition of control of the investment company, this group had defrauded the investment company of $284,000, of which only $15,000 had been recovered as at the date of the Commission's public examination of the investment company in connection with this study.

Upon the discovery of the fraudulent conduct of the Watson group, the former board of directors again assumed the management of the investment company.[1231]

It is obvious from the foregoing recital that the unfortunate history of Oils & Industries, Inc., is partially attributable to the liquidity of the assets of investment companies and the comparative ease with which such assets can be diverted to the use of those in control of these companies, and that control of these companies can be transferred without prior notice to or consent of the stockholders of these companies.[1232] Francis Sullivan, the president of Oils & Industries, Inc., when examined on these aspects, testified:[1233]

Q. You knew of course that Petroleum Research Corporation was going to sell its management contract?

A. Yes.

[1231] For the subsequent history of Oils & Industries, Inc., see infra, pp. 1348–9.

[1232] See, however, *Oil Shares, Inc.*, v. *Kahn, et al.*, 94 F (2d) 751 (C. C. A. 3rd 1938).

[1233] Op. cit. supra, note 1230, at 14224–7.

Q. Now, of course, when the stockholders bought this stock, Mr. Sullivan, they bought it in reliance at least that the other members of the Board were going to be on the Board, isn't that so, and that Petroleum Research Corporation had a 10-year management contract, isn't that so?

A. I think they did.

Q. And then one fine morning they woke up and found that everybody on the old Board was not there any more, including the officers?

A. It is quite true. I admit it * * *.

Q. * * * But as far as the stockholders were concerned, without even the slightest intimation in any official way from the corporation, there was a complete change in management and as soon as the money was turned over the entire board went out and the old Research Corporation is out and a new corporation and new individuals are in there?

A. I think I will have to admit that.

Q. Although the situation was that as far as the stockholders' position or predicament was concerned, if they wanted to get a new management in there they could not do it because Petroleum Research Corporation had a 10-year contract, isn't that so?

A. I think they did have a 10-year contract, that is true.

* * * * * * *

Now the belief, and I am not going to give any excuse now, the belief was that we were helping the company along to get new money into the organization, to select their own advisory capacity and to sell additional securities through this house. With that experience I would not do it again. I will answer your question that way.

Q. And also the situation is that there was always a possibility that the belief might be wrong and then the consequences might be very dire, isn't that so?

A. That is right.

Q. That is particularly true, as I say, in an investment trust, because if you turn a steel plant over to anybody he cannot sell it overnight, but he can sell 10,000 shares of steel overnight, can he not?

A. Yes.

Mr. Sullivan testified further:[1234]

Q. Looking back over that experience, Mr. Sullivan, do you get any ideas with respect to what could be done to protect the investors in that instance? He did not know a thing about this, did he? I mean, he did not know a thing about the fact that there was a contemplated change in management there with respect to the old Board of Directors and the officers and with respect to the advisory contract?

A. I feel now that very full information on any particular change in any organization should be put up to the stockholders themselves so that they may have full knowledge before a change.

* * * * * * *

I think it would be very hard for me to really say how you could guard against an issue of this kind, with people who are talking to you, agreeing with you that they would do certain things. Jackson and Curtis were going to help out in this situation, Carter, Martindell & Company were going to do the advising. Holman Rapp & Company were going to do the selling. When you take these things, what would you put up to your Board? What would you put up to your stockholders? You might put up the matter of liquidation * * * I don't know—

[1234] Id., at 14254–7.

I would take every safeguard that would be possible and I would think about everything and find out.

* * * * * * *

Q. But you can visualize that this situation can be one of easy occurrence, isn't that so?

A. Yes; surely it can.

Q. And it can occur more frequently in the investment trust situation than in the industrial corporation because of the liquidity of their assets. All you have to do is to cross the street, get the key to the vault, and take the securities out, every nickel of them.

A. Yes.

b. To Induce Recommendation of an Exchange Offer

(1) UNION INVESTORS, INC.—YOSEMITE HOLDING CORPORATION

By December 31, 1929 Union Investors, Inc., incorporated by R. B. Parrott in June 1928, had raised $952,860 through the sale of 870 shares of preferred stock, 96,000 shares of Class A stock, and 69,600 shares of Class B stock.[1235] R. B. Parrott, who had awarded to himself a contract to be the sole distributing agent, acquired the bulk of the Class B stock at 50 cents a share.[1236] The Class A stock (as well as the negligible amount of the preferred stock) had been purchased by the directors of the company other than Mr. Parrott and by the general investing public at $9.40 a share. The Class A and Class B stock each had one vote per share.[1237] On dissolution of the corporation, however, the Class A stock which had contributed $9.40 a share to the company was entitled to only two-thirds of the corporate assets remaining after satisfaction of the prior claims of the preferred stock and the Class B stock which had contributed only 50 cents a share to the company was entitled to one-third of such corporate assets.[1238]

By December 31, 1929, the assets of the company had decreased to $680,000,[1239] a depreciation of approximately 30% of the company's original capital; the Class B stock was, nevertheless, entitled to approximately one-third of the remaining corporate assets.

From the summer of 1929, Ray Vance, the president of Union Investors, Inc., and his codirectors had wanted to eliminate Mr. Parrott from the management both because of the latter's lack of success in further distribution of the securities of Union Investors, Inc. and in resentment, apparently, of the unfavorable position which had been accorded the Class A stock, of which Mr. Vance and the other directors held substantial portions (although they also held options which would permit them to secure blocks of Class B common stock at 50 cents a share).[1240] As Mr. Parrott controlled the Class B stock through a voting trust and had an exclusive distribution contract with the company, he could not readily be eliminated without

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[1235] Public Examination, The Equity Corporation, Commission's Exhibit No. 1652.

[1236] Id., at 1665, 1672, and Commission's Exhibit No. 187.

[1237] Id., at 1643–50.

[1238] Ibid. For a detailed discussion of the capital structure of Union Investors, Inc., see Ch. V of this part of the report.

[1239] Op. cit. supra, note 1235, at 1412.

[1240] See Ch. V of this part of the report.

his consent. Nevertheless, by November 1929 Mr. Parrott's consent was obtained to a plan by which control of Union Investors, Inc. was transferred to Yosemite Holding Corporation.

In August 1929 Mr. Vance had met Ralph W. Simonds of Baker, Simonds & Company, a Detroit investment banking house.[1241] As a result of this meeting, an agreement was reached late in September 1929. By this agreement Baker, Simonds & Company and Fidelity Trust Company were to form a holding company which was to engage in the business of acquiring control of other investment companies.[1242] In addition, a management company (later incorporated as Securities Research Corporation) was to be formed, which was to manage the investment companies to be acquired by the contemplated holding company.[1243] Mr. Vance was to head the management company at an annual salary of $12,000 a year—a salary equivalent to twice the salary he had received from Union Investors, Inc.[1244] In fact, Mr. Vance actually received from 1929 to July 1931, $16,950 from Securities Research Corporation.[1245] In addition, Mr. Vance and other directors of Union Investors, Inc. were to receive stock in the management company. Mr. Vance eventually received 2,000 shares of the stock of Securities Research Corporation; George Dyke, another director of Union Investors, Inc., received 500 shares of the management company's stock; and F. W. ter Meulen, another director of Union Investors, Inc., received 50 shares of the stock of Securities Research Corporation.[1246] These shares were awarded to these directors of Union Investors, Inc., as "organization expenses"[1247] of the management company.

Because of the difficulty of raising capital by the public sale of securities,[1248] it was contemplated that the new holding company would raise its initial capital by an exchange offer of its securities for the securities of Union Investors, Inc. Mr. Vance and his codirectors of Union Investors, Inc. agreed to exchange their holdings of 65% of the Class A shares of Union Investors, Inc. for the securities of the new holding company.[1249]

However, as has been noted above, the cooperation of Mr. Parrott was indispensable to the plan.

On November 6, 1929, Baker, Simonds & Company, as representatives of the as yet uncreated holding company, agreed[1250] that the new company, when created, would purchase from Mr. Parrott for the sum of $170,000 the contract between Mr. Parrott and Union Investors, Inc., which gave to Mr. Parrott the right until May 13, 1931, to distribute exclusively the authorized but as yet unissued securities of Union Investors, Inc. This distribution contract had cost Mr. Parrott nothing. Mr. Parrott also agreed to cause the voting trustees of the Class B stock of Union Investors, Inc. to resign

[1241] Op. cit. supra, note 1235, at 1653.
[1242] Id., at 1656 and Commission's Exhibit No. 188.
[1243] Id., at 1680–1.
[1244] Id., at 1682.
[1245] Id., at 1689.
[1246] Id., at 1683.
[1247] Ibid.
[1248] Id., at 1380, 1395.
[1249] Id., at 1398, 1414.
[1250] Id., Commission's Exhibit No. 189.

and to cause the election as voting trustees of representatives of the new company.

Mr. Parrott further agreed to exchange his Class B shares for those of the new company.[1251] Finally, Mr. Parrott agreed that:[1252]

In the event a proposition should be made to stockholders of the Trust [Union Investors] for an exchange of their shares into another corporation and if such exchange is recommended by the Board of Directors of the Trust [Union Investors] then the distributor agrees to exchange any stock that it may hold at such time and agrees to recommend the exchange of such shares of stock to such persons as may request his advice thereon.

It is obvious that the payment of the $170,000 to Mr. Parrott represented the price of his cooperation rather than the intrinsic value of his distribution contract. Mr. Simonds agreed that security distribution following the market crash of October 1929 was extremely difficult. As Mr. Simonds put it, "It was a difficult time to raise money in the regular channels."[1253] In fact, within a few months after Yosemite Holding Corporation (the holding company subsequently formed by Baker, Simonds & Company and Fidelity Trust Company of Detroit) acquired Mr. Parrott's distribution contract for $170,000, it wrote the contract off as worthless.[1254]

Mr. Simonds, however, contended that the payment of $170,000 was made to Mr. Parrott as the only means of acquiring the $650,000 of assets held by Union Investors, Inc.[1255] He further contended that the purchase was necessary in order to eliminate the possibility of the purchase by Mr. Parrott of the 30,400 authorized and unissued shares of the Class B stock of Union Investors, Inc., and the effectuation by Mr. Parrott of a dissolution of Union Investors, Inc., at a large profit on his Class B shares. Mr. Simonds testified:[1256]

Q. Now even on your analysis, isn't it the fact that you were paying, or you were causing Yosemite Holding Corporation to pay $170,000 to get control of $650,000?

A. Yes; it all depends upon your point of view. Now, if we can put ourselves back to the end of 1929, I for one was dead wrong on the economic situation and we had seen a very precipitous decline in securities, and a great many services said that this was not going to be a long drawn out depression, and we had seen the worst, and at the same time it was very hard to raise money because the public had been frightened and the values that existed * * * in some of these trusts looked as though they were valuable because if it was coming right back up again you could afford to pay considerable for the control of that money, you see, and it all depended upon your point of view. Nobody wanted to enrich Parrott here.

Q. I frankly don't understand, if it wasn't for the distribution contract that you paid $170,000, that was a worthless scrap of paper, isn't that so?

A. It was not a worthless scrap of paper.

Q. As a distributing contract?

A. Because it was through the distributing contract which he held exclusively whereby he could have taken this stock at 50 cents a share, that he

[1251] Ibid.
[1252] Ibid.
[1253] Id., at 1395.
[1254] Id., at 1399.
[1255] Id., at 1387.
[1256] Id., at 1386–7.

had the chance to take over a third of the equity in the A stock and all he had to do was to buy the B stock at 50 cents a share, and liquidate the trust, and he would have a lot more than 50 cents a share.

However, in view of the fact that the directors of Union Investors, Inc., held 65% of the Class A stock of the corporation,[1257] a stock with voting rights, it is doubtful that Mr. Parrott could have dissolved Union Investors, Inc., without their assent. Under the Delaware law, an opposing vote of more than one-third of the voting stock of the corporation would have been sufficient to block the dissolution of Union Investors, Inc.[1258] Mr. Vance testified that at least one of the purposes of the payment of $170,000 to Mr. Parrott was to prevent Mr. Parrott from attempting to "switch" Union Investors, Inc. stockholders into the securities of some other investment company:[1259]

Q. * * * Now didn't that provision put a compulsion upon Parrott * * * to recommend to his clients and customers who were seeking his disinterested advice, to recommend that exchange regardless of whether he thought it was of advantage to the stockholders or not, Mr. Vance?

A. I should think that it could be interpreted as putting him under pressure.

* * * * * * *

Q. And the fact of the matter was that he was recommending the exchange regardless of the merit because he had received $170,000; isn't that so? And he had a pecuniary interest in recommending the exchange; otherwise he might be violating his agreement, isn't that so?

A. I wouldn't say I wouldn't agree to it in just those words.

Q. What is your analysis of that?

A. My analysis of the thing is that he wouldn't have made the original contract unless he were willing to go through with this and it was a provision put in to insure that the contract would be carried through, and that Parrott would not after receiving the money attempt to trade out these shareholders into some other company, and he had a certain set of stockholders, and when he came to New York he had no distribution and he came to New York and got most of his distribution, I imagine, through the introduction of his various directors and I think that there may have been some fear that having once gone through this thing thought that he might get up another investment trust, and you have probably heard of this, that directors doing this go back and switch them out, and I think the intent of that was to keep Parrott from switching out after the deal was carried through.

Thus, Mr. Parrott, for a consideration, was contractually bound to recommend acceptance to minority stockholders of Union Investors, Inc., to whom he had sold the securities and in relation to whom he was in a fiduciary position as a director of the corporation, of any exchange offer approved by two-thirds of the directors of Union Investors, Inc. And, on the other hand, Mr. Vance, Mr. ter Meulen, and Mr. Dyke (directors of Union Investors, Inc.), had a pecuniary interest in the success of the exchange offers since they were to receive the stock of Securities Research Corporation, which was to manage the assets of the new holding company, including Union Investors, Inc., and other investment companies which it was contemplated the

[1257] See supra, p. 1297.
[1258] Del. Rev. Code (1935), Ch. 65, § 39.
[1259] Op. cit. supra, note 1235, at 1674–6.

new company would acquire.[1260] In addition, Mr. Vance was to receive from Securities Research Corporation a salary double that which he had received as president of Union Investors, Inc.[1261]

With the cooperation of all the dominant personalities in Union Investors, Inc., thus secured, on November 8, 1929, Yosemite Holding Corporation, the new company which had been contemplated by the parties, was formed in Delaware under the auspices of Baker, Simonds & Company and Fidelity Trust Company of Detroit.[1262] The corporation had an authorized capitalization consisting of a preferred stock, entitled on dissolution of the corporation to a prior claim against its assets to the extent of $51 a share, and a common stock.[1263] The new company immediately raised $266,000 by a sale of units of preferred and common stock to an associate of Baker, Simonds & Company.[1264] Through Baker, Simonds & Company and Fidelity Trust Company of Detroit, Yosemite Holding Corporation publicly offered its preferred stock and common stock at a price equivalent to $50 a share for the preferred stock and $7 a share for the common stock.[1265]

On December 5, 1929, Yosemite Holding Corporation addressed a circular letter[1266] to the Class A and Class B stockholders of Union Investors, Inc., which contained an offer to exchange six-tenths of a share of Yosemite Holding Corporation common stock for each share of Union Investors, Inc., Class B stock and an offer to exchange one and one-half shares of Yosemite Holding Corporation common stock for each share of Union Investors, Inc., Class A stock, or, in the alternative, one share of Yosemite Holding Corporation preferred stock for each five shares of Union Investors, Inc., Class A stock. No offer was made for the small amount of Union Investors, Inc., preferred stock outstanding.[1267] However, this stock was repurchased by Union Investors, Inc., prior to its dissolution in June 1930.[1268]

The offer of Yosemite Holding Corporation did not reveal the fact that Mr. Parrott had for a consideration been induced to recommend acceptance of the offer. Nor did the offer reveal the pecuniary interest of several of Union Investors, Inc., directors in the success of the offer.[1269] In fact, the record does not indicate that stockholders were informed of the intended purpose of Yosemite Holding Corporation to acquire other investment companies—a purpose which substantially deviated from the established policy of Union Investors, Inc., to diversify its security investments.[1270]

Moreover, during the pendency of the negotiations for the exchange offer, Messrs. Vance, ter Meulen, and Parrott, all of whom were directors of Union Investors, Inc., had purchased a total of 27,600 shares of the Class B stock of Union Investors, Inc., at a price of 50 cents a

[1260] See supra, p. 1297.

[1261] Ibid.

[1262] Op. cit. supra, note 1235, at 1367.

[1263] Id., Commission's Exhibits Nos. 185, 195.

[1264] Id., at 1395, 1412.

[1265] Id., at 1402 and Commission's Exhibit No. 192.

[1266] Id., at 1389 and Commission's Exhibit No. 205.

[1267] Ibid.

[1268] Id., at 1416.

[1269] Id., Commission's Exhibit No. 205.

[1270] Derived from supplementary information supplied the Commission for Union Investors, Inc.

share.[1271] This stock was exchanged for Yosemite Holding Corporation stock under the terms of the exchange offer. For each share of the Class B stock of Union Investors, Inc., these directors received six-tenths of a share of Yosemite Holding Corporation common stock which was then being offered at $7 a share to the public.[1272] Taking $7 a share as the market value of Yosemite Holding Corporation common stock, these directors who had invested 50 cents a share on Union Investors, Inc., Class B stock received six-tenths of a share of Yosemite Holding Corporation common stock having a market value of $4.20.[1273] Furthermore, after the acceptance of the exchange offer by more than three-quarters of the Union Investors, Inc.. Class A and Class B stockholders, the asset value of Yosemite Holding Corporation common stock was $2.12.[1274] Thus, on an investment of 50 cents a share for Union Investors, Inc., Class A stock, these directors received Yosemite Holding Corporation stock having an asset value of $1.27. Mr. Vance explained his purchase of the Class B stock as the exercise of an option he had received from Mr. Parrott, prior to the plan for the formation of Yosemite Holding Corporation, to purchase such shares.[1275] The option was intended to constitute additional compensation for Mr. Vance's management service to Union Investors, Inc.[1276] On the propriety of the purchase of the Class B shares by these directors during the pendency of Yosemite Holding Corporation's exchange offer, Mr. Vance testified:[1277]

A. They [the Class B shares] were purchased under contract that Parrott had made with these various directors for their services, as they went along and a good many of them had permitted their rights to purchase that stock to ride.

Q. But these individuals knew, did they not, that the negotiations for the merger with Yosemite were taking place and they participated in that?

A. Yes.

Q. And if they acquired that 27,600 shares of stock they were putting themselves in a position which was much better than the public which had purchased the Class A common stock, isn't that so?

A. That is so, except that two-thirds of the public were themselves.

Q. I am talking about one member of the public, and I am willing to discuss the ethics of that transaction on the basis of one individual who bought one share of that stock, Mr. Vance.

A. All right.

Q. The fact of the matter is, that while these negotiations were going on and while these negotiations were precipitated by the fact that the officers and directors said that they had some ethical compunctions about a person who paid $9.40 for his share of stock not getting the same relative participation as a man paying 50 cents a share, yet during the months of November and December, whether it was on the basis of a previous contract or a contract made at that time that stock was delivered to them.

A. I don't believe that I said that it was ethical compunctions and I think it was financial compunctions. I think the pressure on them was that they

[1271] Op. cit. supra, note 1235, at 1668.
[1272] Id., at 1665 and see supra, p. 1300.
[1273] Id., at 1668.
[1274] Id., at 1672.
[1275] Id., at 1670–1.
[1276] Ibid.
[1277] Id., at 1665–8.

had put up the $9.40 and it was financial pressure on them, on their own money more than what is ethical. I wouldn't consider that that was a matter of ethics. Let us not kid ourselves.

* * * * * * *

Q. So that for each share of the Union Investors Class B stock, they were to get $\frac{6}{10}$ of a share of Yosemite Holding Corporation and at that time they were selling Yosemite stock to the public for $7 a share, isn't that so?

A. It was sold a little later than that, but that was the price.

Q. So that for each share of common of the Class B Union Investors which cost 50 cents, the holder of that Class B common was getting $\frac{6}{10}$ of $7.00 or $4.20.

A. That is right.

Q. And the Class A was getting 1½ shares of Yosemite that is $10.50 for each share of Class A common of Union Investors which cost them $10, isn't that so?

A. Yes, sir.

Q. So that he was getting $10.50 for his $10 while the insiders with the Class B stock were getting $4.20 for their 50 cents, isn't that so?

A. I think that is a fair statement.

As a result of the exchange offer, Yosemite Holding Corporation succeeded in acquiring 99% of the Class A and Class B stock of Union Investors, Inc.,[1278] which was dissolved early in 1930.[1279]

c. To Induce Sponsors to Cause the Investment Company to Issue Stock to Acquirer

(1) GRANGER TRADING CORPORATION—YOSEMITE HOLDING CORPORATION

The acquisition by Yosemite Holding Corporation of Granger Trading Corporation is discussed in detail elsewhere in this report.[1280] However, the facts will be briefly recapitulated at this point.

Granger Trading Corporation was organized in Delaware on January 3, 1929, as a management investment company under the sponsorship of the brokerage firm of Sulzbacher, Granger & Company, members of the New York Stock Exchange.[1281] At the inception of the corporation Sulzbacher, Granger & Company awarded itself a contract to manage the corporation.[1282] Sulzbacher, Granger & Company by this contract was to receive annually as management compensation 20% of the net profits of the company, provided there remained after this deduction from net profits an amount equivalent to 8% of the net capital invested in the corporation. The firm's control of the corporation was further strengthened by the fact that all of the corporation's directors were its partners or employees.

By April 1932 Granger Trading Corporation had net assets of $199,112.68, all of which consisted of actual cash, with the exception of $15,000 which represented the market value of certain bonds owned by the company.[1283] At that time Granger Trading Corporation had

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[1278] Derived from supplementary information supplied the Commission for Union Investors, Inc.

[1279] *Moody's Manual on Investments, Banks, etc.*, 1930, pp. 2794–5.

[1280] See Ch. II of this part of the report, pp. 181–226.

[1281] Op. cit. supra, note 1235, at 2225–6.

[1282] Id., Commission's Exhibit No. 271.

[1283] Id., at 815, 2258, and Commission's Exhibit No. 108.

outstanding 16,294 shares of stock, all of one class.[1284] Of these shares, 3,800, or 25%, were held by members of the Granger family and employees of Sulzbacher, Granger & Company,[1285] and the remaining 12,494 shares were held by the public. The asset value of the Granger Trading Corporation stock was $12.22 a share.[1286]

In April 1932 Wallace Groves, then in control of Yosemite Holding Corporation, on behalf of that corporation, contacted Sulzbacher, Granger & Company with a view to acquiring control of Granger Trading Corporation. At that time the 3,800 shares of the stock of Granger Trading Corporation held by the Granger family was an amount insufficient to have given Yosemite Holding Corporation majority control. Sulzbacher, Granger & Company, however, was in a position, through its control of the Granger Trading Corporation's directorate [1287] and by virtue of its management contract,[1288] to cause the issuance by Granger Trading Corporation of an amount of its authorized stock sufficient, when coupled with the holdings of the Granger family and their associates, to give substantial control to Yosemite Holding Corporation.

Accordingly, on April 20, 1932, Granger Trading Corporation sold to Yosemite Holding Corporation at $12.22 a share (the then asset value of the stock) 7,500 shares of its authorized but as yet unissued stock for $91,650.[1289] This sale increased the Granger Trading Corporation's assets to approximately $290,762.68. On the same day Yosemite Holding Corporation purchased for $19,500 the management contract held by Sulzbacher, Granger & Company, which had never resulted in any compensation to Sulzbacher, Granger & Company.[1290] On April 21, 1932, Yosemite Holding Corporation purchased from members of the Granger family and from employees of Sulzbacher, Granger & Company their total holdings of 3,800 shares of the stock of Granger Trading Corporation at a price equal to the asset value of the stock—$12.22 a share.[1291]

Thus, by April 21, 1932, Yosemite Holding Corporation had obtained 11,300 shares of the stock of Granger Trading Corporation, or approximately 47% of the 23,794 shares of its outstanding stock. By April 21, 1932, all of the former directors of Granger Trading Corporation, with the exception of Jeffrey Granger, had been supplanted by nominees of Yosemite Holding Corporation, that is, by Wallace Groves.[1292] In May 1932 Granger Trading Corporation sold all of its assets to Yosemite Holding Corporation in return for stock of the latter corporation. This transaction and the resultant losses suffered by minority stockholders of Granger Trading Corporation is described in more detail in a subsequent section of this chapter.[1293]

1284 Id., at 841.

1285 Id., at 2281.

1286 Id., at 2258–9.

1287 Id., at 2229.

1288 See supra, p. 1302.

1289 Op. cit. supra, note 1235, at 2267.

1290 Id., at 2559–61. In addition, Yosemite Holding Corporation paid $6,000 to Sulzbacher, Granger & Company for the cancelation of a lease between the firm and Granger Trading Corporation (id., at 2261).

1291 Id., at 2258.

1292 Id., at 2265.

1293 See infra, pp. 1480–5.

4. CONTINUANCE OF ORIGINAL SPONSOR'S BROKERAGE BUSINESS

Brokers who had been associated with investment companies prior to the passage of control to new interests frequently continued, as a matter of tacit if not express agreement, to receive brokerage business from the acquiring corporation or individual. Thus, a majority of the ten brokers who, in each of the years 1931 to 1935, inclusive, received the largest amount of Atlas Corporation's brokerage business, had previously acted as brokers and sponsors for investment companies, control of which had passed to Atlas Corporation. The following schedule indicates the names of nine brokers who were included among the ten brokers who received the largest amount of brokerage business from Atlas Corporation and its investment company subsidiaries, the year in which they appeared in the group, and the Atlas Corporation controlled companies with which they had previously been connected:[1294]

Name of brokerage firm	Company with which firm or a partner thereof had been associated	Year associated
Fenner, Beane & Ungerleider	Ungerleider Financial Corporation	1931–1932
Field, Glore & Co. (now Glore, Forgan & Co.).	Aviation Securities Corporation	1931–1932
Hemphill, Noyes & Co	General Empire Corporation	1931
Goldman, Sachs & Co	The Goldman Sachs Trading Corporation Shenandoah Corporation Blue Ridge Corporation	1931–1935
Quaw & Foley	Selected Stocks, Inc	1931–1935
Hayden, Stone & Co	Sterling Securities Corporation	1931–1935
F. S. Smithers & Co	Atlantic Securities Corporation	1932
Tucker, Anthony & Co	American Investors, Inc	1933
Shields & Co., Inc	Chain Store Stocks, Inc	1931–1935

With the exception of Goldman, Sachs & Co. and Tucker, Anthony & Co., all of these firms were directly instrumental in effecting a transfer of the control of their companies to Atlas Corporation. In some cases these firms received other considerations from Atlas Corporation, such as on the purchase of their stock and option warrants. Quaw & Foley [1295] and F. S. Smithers & Co.[1296] recommended the acceptance of exchange offers made by Atlas Corporation to the stockholders of their companies. None of the firms mentioned opposed exchange offers made by Atlas Corporation to their stockholders. For example, the original exchange offer [1297] made by Atlas Corporation on June 14, 1932, to the stockholders of The Goldman Sachs Trading Corporation was not actively opposed by Goldman, Sachs & Co., even though it disapproved of the terms of the offer.[1298] Goldman, Sachs & Co., however, caused to be published in newspapers a statement that the offer was the private affair of the stockholders, and the firm did publicly

[1294] Derived from supplementary information supplied the Commission for Atlas Corporation.

[1295] Public Examination, Atlas Corporation, Commission's Exhibit No. 1970.

[1296] See *Atlantic Securities Corporation*, supra, pp. 1247–58.

[1297] Op. cit. supra, note 1295, Commission's Exhibit No. 1970.

[1298] Id., at 17955–6 and 17959.

announce that it was not exchanging its own shares of the stocks of The Goldman Sachs Trading Corporation.[1299]

Although these firms may have in good faith believed the terms of the exchange offer were fair to the stockholders of the companies which they had sponsored, the tacit agreement of Atlas Corporation to continue to do a brokerage business with these firms may have tended to bias them in favor of Atlas Corporation and its exchange offers. Moreover, the fact that these firms were receiving brokerage business from Atlas Corporation was not revealed to the stockholders of the companies which they had sponsored.

In most cases the use of these brokerage houses by Atlas Corporation was, as has been stated, a matter of tacit agreement. In one case, however—that of Chain Store Stocks, Inc.—the consideration for a shift in control of the company to Atlas Corporation by its sponsors included an express agreement by Atlas Corporation to grant to its sponsor, Shields & Company, Inc., a stipulated dollar amount of brokerage business for a period of five years. Mr. Odlum testified:[1300]

Q. And you also concede situations where you made a promise of brokerage commissions, although those individuals didn't have any stock, and you weren't getting control of the assets by stock ownership?

A. That was true in only one case; but in all cases, no matter whether the brokers dealing with the situation had stock or management contracts or were sponsors, we told all brokers that our purpose was not to sever established connections, and all things being equal we would expect to give a fair quota of our business to the people who had theretofore been dealing with the company.

Q. And do you say, Mr. Odlum, that even after Atlas Corporation got control of a particular situation they would continue to dispense the brokerage business to the old sponsor, even though they didn't have any stock in the situation, and that there was no element whatsoever of these people cooperating with you in the exchange program?

A. No; we gave it sometimes to brokers who were actively opposed to us.

Q. But you gave it to brokers actively engaged in soliciting for you?

A. We gave it to the old brokerage connections, no matter who they were. We didn't cut them off.

Similarly, Tri-Continental Corporation, which in the period 1931 to 1933 exchanged its securities for the assets of three investment companies, Investors Equity Co., Inc., Wedgwood Investing Corporation, and Graymur Corporation, agreed after each acquisition to continue the brokerage business of the former sponsors of the acquired companies. Joseph Walker & Sons, one of the sponsors of Wedgwood Investing Corporation, received for a period of four years after the sale of Wedgwood Investing Corporation's assets to Tri-Continental Corporation, 3.75% of the latter's brokerage business; C. D. Barney & Co., the sponsors of Investors Equity Co., Inc., received 5% of Tri-Continental Corporation's brokerage business following the sale of Investors Equity Co., Inc.'s assets to Tri-Continental Corporation; and G. M.-P. Murphy & Co., the sponsors of Graymur Corporation, following the sale of its assets to Tri-Continental Corporation, received 6.76% of the latter's brokerage business.[1301] Earle Bailie, the chairman of the board

[1299] Id., Commission's Exhibit No. 1983.
[1300] Id., at 17780–1.
[1301] Public Examination, Tri-Continental Corporation, at 18677–80.

of directors of Tri-Continental Corporation, denied that these brokerage commissions to the sponsors of the acquired companies were part of the arrangements for the acquisition of these companies by Tri-Continental Corporation, although he conceded that in some cases there was an "understanding" that brokerage business would be given to such sponsors after the acquisition of their companies. Mr. Bailie testified: [1302]

Q. A lot of these deals were made at the time when the companies were acquired to take care of the sponsor interests?

A. There were none of them made until after each acquisition.

Q. They were part of the acquisition, weren't they?

A. You say so * * * I say no.

Q. You say no?

A. No; they came about after the acquisition.

Q. You say there is no definite——

A. (Interposing). There was no definite agreement whatever at the time of the acquisition.

Q. No mention in any case?

A. Once or twice there was mention of it, and in each case the understanding was that we would satisfy them after the deal was over * * *.

In the case of both Investors Equity Co., Inc., and of Graymur Corporation, the stockholders received Tri-Continental Corporation securities having a lesser asset value than their own securities, although the market value of the Tri-Continental Corporation securities exceeded the market value of their own securities.[1303] In each of these cases the sponsors recommended the acceptance by the stockholders of their companies of the securities offered by Tri-Continental Corporation for the assets of their companies.[1304] However, in none of the communications to the shareholders of the selling corporation was it revealed that Tri-Continental Corporation had agreed that the sponsors were to continue to receive brokerage business from Tri-Continental Corporation.[1305] Although the sponsors may have acted in good faith in recommending the acceptance of Tri-Continental Corporation's offers, nevertheless the opportunity to continue to receive the principal emolument of their former connection with their companies, without the burden of the future management of such companies, may have acted to bias them in favor of the acquiring company's offer irrespective of the merits of such offer from the point of view of the stockholders of the acquired companies.

a. Chain Store Stocks, Inc.—Atlas Corporation

Chain Store Stocks, Inc., was incorporated in Maryland on December 3, 1928,[1306] as a joint promotion of the New York investment banking firms of Shields & Company, Inc., E. Naumberg & Co., and F. S. Smithers & Co.,[1307] and was intended to furnish a medium for invest-

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[1302] Id., at 18679.

[1303] Id., at 18580, 18586.

[1304] Reply to the Commission's questionnaire for Investors Equity Co., Inc., Pt. I, Exhibit A2; reply to the Commission's questionnaire for Graymur Corporation, Pt. I, Exhibit 14.

[1305] Ibid.

[1306] Public Examination, Chain Store Stocks, Inc., Commission's Exhibit No. 1620.

[1307] Id., at 15608 and Commission's Exhibit No. 1621.

ment in chain-store companies by the customers of the three firms.[1308] Although the investment company had general power to deal in any securities and to participate in underwritings and syndicates, the prospectus stated that the purpose of the corporation was to invest "primarily in the securities of chain-store and other merchandising companies."[1309]

Prior to the actual formation of the corporation, discussions between Shields & Company, Inc. and Harrison Williams, who controlled a majority of the common stock of Central States Electric Corporation, which in turn controlled American Cities Power & Light Corporation,[1310] led to a commitment upon the part of American Cities Power & Light Corporation to purchase one-fifth of the shares of Chain Store Stocks, Inc., if, when, and as issued.[1311]

The authorized capitalization of Chain Store Stocks, Inc., consisted of 1,000,000 shares of capital stock, all of one class and all without par value.[1312] On December 13, 1928, Shields & Company. Inc., E. Naumberg & Co., and F. S. Smithers & Co. entered into a contract[1313] with the corporation to "find purchasers" for 300,000 shares of the corporation's stock at a price, to be paid by the purchasers, of $37.50 a share. The bankers were permitted to retain as a commission $3 for each share sold, and the corporation was to receive $34.50 for each share sold.[1314] As further compensation to the bankers, they were to receive option warrants to purchase 100,000 shares of the corporation's stock on or before January 1, 1934, at a price of $37.50 a share.[1315]

Of the 300,000 shares to be sold by the bankers, American Cities Power & Light Corporation purchased 60,000 shares, Shields & Company, Inc. purchased for its own account 36,000 shares, and E. Naumberg & Co. purchased 7,200 shares. All of these shares were purchased at a price of $35 a share. On these shares the corporation thus received $35 a share rather than $34.50 a share. The remaining shares were sold to the public at $37.50 a share, the bankers retaining as a commission $3 a share and remitting $34.50 a share to the corporation. As a result of this financing, $10,416,000 was contributed to the corporation. The bankers each received as gross underwriting commissions approximately $280,000, or an aggregate of $840,000.[1316]

The prospectus[1317] offering the shares to the public did not reveal the substantial stock interest of American Cities Power & Light Corporation in, and its connection with Chain Store Stocks, Inc.

The 100,000 option warrants were divided equally among American Cities Power & Light Corporation, Shields & Company, Inc., E. Naumberg & Co., and F. S. Smithers & Co.[1318] These companies jointly managed the affairs of Chain Store Stocks, Inc., until Sep-

[1308] Id., at 15607–8, 15611.
[1309] Id., Commission's Exhibit No. 1621.
[1310] Id., at 15609.
[1311] Id., at 15625.
[1312] Id., at 15612 and Commission's Exhibit No. 1620.
[1313] Id., Commission's Exhibit No. 1622.
[1314] Id., at 15612 and Commission's Exhibit No. 1622.
[1315] Id., at 15612–3 and Commission's Exhibit No. 1622.
[1316] Id., at 15622–31.
[1317] Id., Commission's Exhibit No. 1621.
[1318] Id., at 15613–4.

tember 1929. Representatives of each of the four companies constituted the entire board of directors of Chain Store Stocks, Inc.

In September 1929 E. Naumberg & Co. and F. S. Smithers & Co., because of their disagreement with a proposal of American Cities Power & Light Corporation that Chain Store Stocks, Inc., increase its capital by offering $50,000,000 of optional convertible preferred stock of Chain Store Stocks, Inc., to the public,[1319] severed their connection with that investment company and sold their option warrants to Shields & Company, Inc., for an aggregate sum of $300,000, which was divided equally between them.[1320] In addition, Shields & Company, Inc., purchased the 7,200 shares of the investment company's stock held by E. Naumberg & Co. at $37.50 a share.[1321] Shields & Company, Inc., simultaneously sold 10,000 shares of its holdings of the stock of Chain Store Stocks, Inc., to United States & Foreign Securities Corporation,[1322] an investment company controlled by the New York investment banking firm of Dillon, Read & Co.[1323] The 100,000 option warrants were then redistributed among American Cities Power & Light Corporation, United States & Foreign Securities Corporation, and Shields & Company, Inc., each company receiving one-third of the warrants.[1324] United States & Foreign Securities Corporation representatives were elected to the Board of Directors of Chain Store Stocks, Inc., to replace the representatives of E. Naumberg & Co. and F. S. Smithers & Co., who had resigned.[1325]

From December 1929 to September 1931, when Atlas Corporation acquired control of the corporation, Chain Store Stocks, Inc., purchased 50,500 shares of its own stocks at a total cost of $650,074.[1326] Treating this sum expended by the corporation in the repurchase of its own shares as in effect a return of capital to the stockholders, the net capital contributed to the corporation by the holders of its outstanding 254,000 shares (4,500 shares had been distributed as a stock dividend in 1929) in September 1931 was $9,765,926. The net worth of the corporation in September 1931 was $3,407,167.47.[1327] Thus, during the period of the management of the corporation by American Cities Power & Light Corporation, Shields & Company, Inc., and United States & Foreign Securities Corporation, the corporation's losses, realized or unrealized, approximated 65% of the net capital contributed to the corporation by the holders of its outstanding stock.

Initially, the corporation's investments were in accordance with its declared primary purpose to invest in the securities of chain store companies. However, in May 1929, the corporation sharply altered its previous policy and borrowed $2,000,000[1328] to invest in a diversified list of securities. Mr. Shields explained that this change in policy, which was not revealed to the corporation's stockholders until

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[1319] Id., at 15648, 15655, et seq.

[1320] Id., at 15617–8.

[1321] Id., at 15624.

[1322] Id., at 15626 and derived from supplementary information supplied the Commission for Chain Store Stocks, Inc.

[1323] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. V, pp. 425–6.

[1324] Op. cit. supra, note 1306, Commission's Exhibit No. 1629, and derived from supplementary information supplied the Commission for Chain Store Stocks, Inc.

[1325] Op. cit. supra, note 1306, at 15655.

[1326] Id., Commission's Exhibit No. 1630.

[1327] Op. cit. supra, note 1295, Commission's Exhibit Nos. 2003 and 2043.

[1328] Op. cit. supra, note 1306, at 15657.

December 31, 1929, was due to the poor market behavior of chain-store securities in May 1929, caused by rumors of incipient state taxation of chain stores.[1329] He conceded, however, that stockholders should have been informed of the corporation's intent to change its investment policy prior to the actual occurrence of such change.[1330]

The investment policy of the corporation was characterized by a marked predilection for the securities of companies in which the managers of Chain Store Stocks, Inc., were interested. Investments were made in the securities of Peoples Drug Stores, Inc., Metropolitan Chain Stores, Inc., and Walgreen Company. Shields & Company, Inc., were bankers for these companies.[1331] In addition, investments were made in the common and preferred stocks and the debentures of Commercial Investment Trust Corporation, a company for which Dillon, Read & Co. were bankers. Investments were also made by Chain Store Stocks, Inc., in the securities of various companies with which Harrison Williams was identified, such as Electric Shareholdings Corporation, American Cities Power & Light Corporation, The North American Company, Blue Ridge Corporation, and Shenandoah Corporation.[1332]

A total of $4,084,872.66, or 40% of the total capital of Chain Store Stocks, Inc., was invested in the securities of these companies with which the managers of Chain Store Stocks, Inc., were associated. As at September 16, 1931, when Atlas Corporation acquired control of the corporation, the loss, realized and unrealized, suffered by Chain Store Stocks, Inc., in these investments was $1,480,783.18.[1333]

In some cases securities owned by the managers themselves were sold to Chain Store Stocks, Inc. On December 13, 1928, virtually at the inception of Chain Store Stocks, Inc., Shields & Company, Inc., sold to the corporation 7,500 shares of Walgreen Company common stock at a price of $88 a share, and 6,000 shares of the common stock of Peoples Drug Stores, Inc., at a price of $87 a share.[1334] On that day the highest market price of Walgreen Company common stock was $84, so that the shares were sold to Chain Store Stocks, Inc., by Shields & Company, Inc., at a price $4 above the market price.[1335] Similarly, on the same day, the market price of Peoples Drug Stores, Inc., stock was $82 a share, so that Chain Store Stocks, Inc., paid to Shields & Company, Inc., $5 a share in excess of the market price of the stock.[1336] The purchase of these two securities by Chain Store Stocks, Inc., involved an expenditure of $1,182,000, the equivalent of over 10% of the total capital raised by Chain Store Stocks, Inc.[1337] On these securities the corporation eventually suffered a loss of approximately 34% of their cost price.

By July 1931, Shields & Company, Inc., no longer desired the responsibility of managing Chain Store Stocks, Inc. Paul V. Shields, of the firm of Shields & Company, Inc., testified that his firm had

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[1329] Id., at 15633.
[1330] Id., at 15670, et seq.
[1331] Id., at 15633–6.
[1332] Id., at 15633–5, 15672–4.
[1333] Id., at 15674.
[1334] Id., at 15633–4.
[1335] Id., at 15634.
[1336] Id., at 15635.
[1337] Id., at 15636. The total capital contributed to Chain Store Stocks, Inc., it will be recalled, was $10,416,000.

lost a "little confidence in our ability to manage the money and it might be well to pass the responsibility on to someone else." [1338] Furthermore, Mr. Shields admitted the continued unsuccessful career of Chain Store Stocks, Inc., might have injured the brokerage business of Shields & Company, Inc.[1339]

Some thought was given by the managers of Chain Store Stocks, Inc., to the possibility of liquidating the corporation.[1340] Mr. Shields, however, testified that large minority stockholders with whom he had discussed the matter had decided that they wished the corporation to continue.[1341] Presumably, also, a dissolution of the corporation at a time when its operations had resulted in large losses to its stockholders would have reflected upon the prestige and reputation of Shields & Company, Inc.[1342]

Late in July 1931 David G. Baird, one of the individuals who were engaged in "finding" investment companies for Atlas Corporation, sounded out Shields & Company, Inc., on the possibilities of transferring control of Chain Store Stocks, Inc., to Atlas Corporation.[1343]

Early in the negotiations, Atlas Corporation discovered that Shields & Company, Inc., owned only 57,534 shares of Chain Store Stocks, Inc.[1344] American Cities Power & Light Corporation then held 72,105 shares of the corporation's stock; United States & Foreign Securities Corporation held 10,161½ shares; and Harrison Williams, personally, and his associates owned 10,855 shares of the stock of Chain Store Stocks, Inc.[1345] In all, 150,655½ shares were held by these parties. The shares so held constituted 60% of the 254,000 outstanding shares of Chain Store Stocks, Inc.[1346]

The negotiations of Atlas Corporation with Shields & Company, Inc., were accordingly broadened to include within their scope the acquisition of the shares held by American Cities Power & Light Corporation, United States & Foreign Securities Corporation, and Harrison Williams and his associates.[1347]

On September 18, 1931, the negotiations culminated in a contract [1348] between the parties wherein Atlas Corporation agreed to purchase the stock of Chain Store Stocks, Inc., held by American Cities Power & Light Corporation, United States & Foreign Securities Corporation, and Shields & Company, Inc., at a price of $13.40 a share, the liquidating value of such stock at September 16, 1931. Atlas Corporation also agreed to purchase the shares held by Harrison Williams and his associates at a price of $10.50 a share. The 100,000 Chain Store Stocks,

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[1338] Public Examination, Chain Store Stocks, Inc., at 15638.

[1339] Id., at 15679–80.

[1340] Id., at 15680–1.

[1341] Ibid.

[1342] Mr. Shields testified (ibid.):

> Q. Isn't there this element too, that any further continued unsuccess with the investment trust would rebound to the disadvantage of the brokerage firm, isn't that so?
> A. I think that may have been in our mind. I don't know that that was so, or the dominant thing.
> Q. In any event, you though that you had enough?
> A. We knew we had enough.

[1343] Id., at 15689.

[1344] Ibid.

[1345] Id., at 15681–3.

[1346] Id., at 15681–2 and Commission's Exhibit No. 1629; op. cit. supra, note 1295, Commission's Exhibit No. 2001.

[1347] Op. cit. supra, note 1306, at 15682; op. cit. supra, note 1295, Commission's Exhibit No. 2001.

[1348] Op. cit. supra, note 1306, Commission's Exhibit No. 1629.

Inc., warrants held by the sellers were to be included in the sale gratis. Since the market price of Chain Store Stocks, Inc., stock was then approximately $8 a share, the total price to be paid by Atlas Corporation on these shares was approximately $778,075.12 above the market value of the shares.[1349]

Atlas Corporation, as further consideration for the shares of Chain Store Stocks, Inc., sold to it by Shields & Company, Inc., agreed that it would cause "to be done with you [Shields & Company] during a period of five years from the date hereof a stock or securities brokerage business, the commissions on which will aggregate $100,000 during such period of five years." [1350]

Paul V. Shields testified that, to May 14, 1937, Shields & Company, Inc., had received brokerage commissions totaling $60,000 from Atlas Corporation, and that Atlas Corporation is "continuing to do business" with his firm under the agreement of September 18, 1931.[1351]

In addition, the agreement of September 18, 1931, bound Shields & Company, Inc., and the other sellers of Chain Store Stocks, Inc., to Atlas Corporation, "to refrain from taking any position in the market and option warrants of Chain Store Stocks, Inc., from this date on except with the consent of Atlas Corporation." [1352] The purpose of this provision was to place Atlas Corporation in control of the market price of the shares of Chain Store Stocks, Inc. This purpose is clearly indicated in a memorandum [1353] dated September 2, 1931, written to David G. Baird by John W. Donaldson, a vice president of Atlas Corporation, with reference to the status of the negotiations by Atlas Corporation for the acquisition of control of Chain Store Stocks, Inc. The memorandum stated:

> Shields & Company to agree to cooperate with Atlas to the end that the existing market on Chain Store Stocks, Inc., will be left open so that Atlas may acquire such stock as comes on the market at the most advantageous price to Atlas Corporation.

Mr. Odlum testified that the language of the memorandum "might lead to the conclusion" that Atlas Corporation's purpose in causing Shields & Company, Inc., to refrain from further dealing in the stock of Chain Store Stocks, Inc., was to acquire control of the market price of Chain Store Stocks, Inc.'s, shares. The fact that Atlas Corporation subsequently acquired the securities of Chain Store Stocks, Inc., in the market at advantageous prices is evident from Mr. Odlum's testimony that subsequent market purchases of Chain Store Stocks, Inc., securities held by the public were made by Atlas Corporation

[1349] Ibid., and op. cit. supra, note 1295, Commission's Exhibit No. 2001.

[1350] Op. cit. supra, note 1306, Commission's Exhibit No. 1629. Mr. Shields testified that the $100,000 figure for 5 years, or $20,000 a year, was not based on the average annual brokerage business which Shields & Company, Inc. had previously obtained from Chain Store Stocks, Inc., but was based on getting "anything we could get" (id., at 15688):

> Q. Was the $100,000 figure for five years predicated upon what the average per year had been for Shields & Company?
> A. No. Well, I didn't negotiate the $100,000 figure. We were trying to get anything we could get and that was just a figure that came to me that they (Atlas Corporation) could afford to pay in brokerage, considering that they had them a volume of around $50,000,000 and they were going to pay these commissions to someone.

[1351] Id., at 15687.

[1352] Id., Commission's Exhibit No. 1629.

[1353] Op. cit. supra, note 1295, Commission's Exhibit No. 1999.

at prices which averaged 76% of the actual asset value of the stock when purchased. These prices, however, were in excess of the market prices of comparable investment company securities which were selling generally at 70% of their asset value. Mr. Odlum's testimony was as follows:[1354]

Q. The stockholders there, too, found themselves in the predicament with the sponsor who may have been sponsoring the market, pulling the peg, isn't that so? You may say that it is permitting the stock to get to its natural level, but the ultimate effect is when the peg is pulled the price does decline and Atlas is going to acquire their shares at the most advantageous prices for itself, isn't that true?

A. That language might lead to that conclusion, yes. On the question of Chain Store Stocks, Inc., on all of the purchases that we made we paid 76% of asset value for, and the market on other nonleverage stocks for the same period was 69.9% (of asset value) * * *.

Although Shields & Company, Inc., refrained, in accordance with its agreement, from dealing in the securities of Chain Store Stocks, Inc., after Atlas Corporation acquired control of the corporation, the firm did not further cooperate with Atlas Corporation in securing exchanges of Chain Store Stocks, Inc.'s, securities for Atlas Corporation securities, nor did it aid Atlas Corporation in purchasing the remaining shares of Chain Store Stocks, Inc., in the open market. Mr. Shields testified that he would not have "approved"[1355] of such activities upon the part of his firm, which had previously sponsored and sold to the public the securities of Chain Store Stocks, Inc. Shields & Company, however, did not actively oppose the Atlas Corporation exchange offers when they were made.

As has been stated, the market price of the stock of Chain Store Stocks, Inc., became solely within the control of Atlas Corporation as the only bidder for the stock in the market. On its acquisition of control of Chain Store Stocks, Inc., on September 16, 1931, Atlas Corporation terminated the repurchases by Chain Store Stocks, Inc., of its own stock. Not until September 16, 1932, did Chain Store Stocks, Inc., resume purchasing its own stock.[1356]

Minority stockholders of Chain Store Stocks, Inc., were not informed of the transfer of control of their corporation to Atlas Corporation prior to its occurrence. Further, Mr. Shields testified that a contemporaneous offer on the part of Atlas Corporation to purchase the stock of minority stockholders on the same terms on which Atlas Corporation had purchased the stock of the managers of Chain Store Stocks, Inc., was not "practicable". Mr. Shields testified:[1357]

Q. Now, this agreement did not provide that Atlas Corporation was to make the same offer to the other stockholders?

A. No.

Q. And, of course, the stockholders were not apprised before the sale took place that the sale was going to take place, and that the management was going to pass to the Atlas interests?

A. No; they weren't.

[1354] Id., at 18087.

[1355] Op. cit. supra, note 1306, at 15694.

[1356] Id., Commission's Exhibit No. 1630.

[1357] Id., at 15685–7.

Q. Well, let us do some retrospecting again. Don't you think that it would have been, shall we say, more advisable to have apprised the stockholders that there was going to be a distinct change in management of their funds by the sale of stock by yourself and the Williams group?

A. Well, I suppose, practically, immediately following our contract with them, we should have notified them; yes.

Q. Well, you said "immediately after" and then, of course, at that moment of time, he is under a new management, isn't he?

A. Yes, sir. Well, practically though, could you have done it before and still effected a trade? You would have had probably a lot of chaos, and they were very difficult times, as you know, and right at that particular time was the most severe of the market decline.

* * * * * * *

Q. So that so far as Shields and Harrison Williams were concerned, they were getting their liquidation value, which was in excess of the market value by approximately $6 a share?

A. Yes, sir.

Q. But no provision was made that a similar offer should be made to other stockholders who wanted to get out at that time?

A. No.

Q. Was there any discussion as to that, do you recall?

A. Discussion of what?

Q. Discussion as to whether a similar offer should be made to other stockholders.

A. Yes; as I recall, there was a discussion, but it just wasn't practicable to do it.

Q. You mean that they [Atlas Corporation] couldn't make their money that way, giving you dollar for dollar when the market was six points below that?

A. Well * * *.

Q. Isn't that so?

A. I don't mean that—I just don't believe that—it is difficult now, five years afterwards to put yourself back in the fall of 1931, but you were going through a very chaotic time, and rumors were flying, and one thing I was particularly concerned about at the time, I know, was the reflection on our general business, and they had everybody busted every third day, and you had to be pretty careful that rumors wouldn't be started about your condition.

It will be recalled that minority stockholders of Chain Store Stocks, Inc., who later sold their shares to Atlas Corporation, received an average price equivalent to 76% of the asset value of their stock, and, as will be described later, stockholders of Chain Store Stocks, Inc., who exchanged their shares for the stock of Atlas Corporation, received stock having an asset value less than the asset value of their own shares. In contrast, the management of Chain Store Stocks, Inc., had received the actual asset value of their shares.

Atlas Corporation did not itself purchase the holdings of the former managers of Chain Store Stocks, Inc. Rather, they were purchased by Chatham Phenix Allied Corporation, control of which had been acquired by Atlas Corporation only a month before.[1358]

On September 18, 1931, Chatham Phenix Allied Corporation purchased the 150,655½ shares of Chain Store Stocks, Inc., from the former sponsors and managers of Chain Store Stocks, Inc., for a total

[1358] See *Chatham Phenix Allied Corporation*, supra, pp. 1142–57.

of $1,983,319.12, a price $778,075.12 above the market value of the shares. Thereafter, Chatham Phenix Allied Corporation's funds were expended in the further purchase in the market of Chain Store Stocks, Inc., shares. By December 31, 1931, Chatham Phenix Allied Corporation held 167,611½ shares of the stock of Chain Store Stocks, Inc., or 67% of the 254,000 shares of that corporation then outstanding.[1359]

On June 4, 1932, Atlas Corporation, as one of 12 simultaneous offers made to the stockholders of its controlled companies, offered to exchange four-fifths of a share of its common stock for each share of Chain Store Stocks, Inc., held by the public. The offer revealed that the asset value of each share of Chain Store Stocks, Inc., was $7.60, based on an evaluation of its portfolio at market prices, but further stated that "if the holdings of stock in your company [Chain Store Stocks, Inc.] in affiliated investment trusts are appraised at their asset value rather than at their market value this figure would be somewhat increased." The asset value of the Atlas Corporation stock offered was then $2.38, but this fact was not revealed in the offer.[1360] However, the offering letter did state that the asset value of four-fifths of a share of Atlas Corporation's common stock would be $5.84 if all of the minority stockholders of the 12 investment companies, for the securities of which Atlas Corporation was then making exchange offers, accepted such offers.

Stockholders of Chain Store Stocks, Inc., who accepted the offer suffered a gross loss in asset value of $5.22 a share of their stock on the basis of an asset value of $2.38 for the Atlas Corporation stock received. On the basis of the hypothetical asset value of $5.84 for the Atlas Corporation common stock received by them, Chain Store Stocks, Inc., stockholders would suffer an asset value loss of $1.76 a share of their stock. The market value of the shares of Chain Store Stocks, Inc., was the same as that of the shares of Atlas Corporation to be exchanged therefor.[1361]

As a result of this offer, Atlas Corporation acquired 47,973½ shares of the stock of Chain Store Stocks, Inc. The gain in asset values to Atlas Corporation as the result of the exchange was $249,683,[1362] based on an asset value of $2.38 for each four-fifths of a share of its common stock issued on the exchange.

On September 16, 1932, another technique was adopted by Atlas Corporation to reduce the number of outstanding shares of Chain Store Stocks, Inc., at a profit to Atlas Corporation. On that date, Chain Store Stocks, Inc., itself made an offer [1363] to its stockholders to repurchase its own stock at lowest tender prices not to exceed $7 a share. As a result of this offer, Chain Store Stocks, Inc., acquired and retired 3,317 shares of its own stock which cost it an average of $6.96 a share. However, the asset value of these shares was $9.72 a share as at December 31, 1932, so that the retirement of the shares purchased by the corporation increased its surplus by $9,154.92. Nine-

[1359] Op. cit. supra, note 1295, Commission's Exhibit No. 2001.

[1360] Id., Commission's Exhibits Nos. 1970, 2001.

[1361] Id., Commission's Exhibit No. 2001.

[1362] Ibid. However, stockholders of Chain Store Stocks, Inc., who exchanged their shares, by becoming stockholders of Atlas Corporation, recovered a portion of their loss in asset values.

[1363] Id., Commission's Exhibit No. 1970.

tenths of this increase in surplus primarily benefited Atlas Corporation which then owned 90% of the outstanding stock of Chain Store Stocks, Inc.[1364]

On June 13, 1933 Atlas Corporation, in a circular letter [1365] to Chain Store Stocks, Inc. stockholders, offered to exchange eight-tenths of a share of Atlas Corporation's common stock for each outstanding share of the stock of Chain Store Stocks, Inc. The letter did not reveal the comparative asset values of the two securities.[1366] As at May 31, 1933, the asset value of each share of Chain Store Stocks, Inc. was $12.65.[1367] The asset value of the Atlas Corporation stock offered as at the same date was $8.56. Stockholders of Chain Store Stocks, Inc., accepting the offer, suffered a gross loss in assets per share of their stock of $4.09. However, the market value of the Atlas Corporation common stock offered exceeded the market value of the Chain Store Stocks, Inc. share by $3.30.[1368]

This offer resulted in the acquisition by Atlas Corporation of 13,506 shares of the stock of Chain Store Stocks, Inc. The gain in asset values to Atlas Corporation on the exchange, based on the asset values of the exchanged securities as at May 31, 1933, was $53,155. On October 17, 1933, Atlas Corporation and Chatham Phenix Allied Corporation, which then held a total of 220,205 shares of the stock of Chain Store Stocks, Inc., 95% of that corporation's outstanding stock, voted to dissolve the corporation. At the date of the dissolution of Chain Store Stocks, Inc., its net worth, appraising its portfolio holdings at market value, was $2,625,852.76, equivalent to $11.32 a share on the 231,191 outstanding shares of the corporation's stock.[1369] Minority stockholders received as a liquidating dividend $11.32 a share [1370] on their stock in cash, or, if they so desired, in portfolio securities of a market value equivalent to $11.32 a share on their stock.

Atlas Corporation and Chatham Phenix Allied Corporation received in cash and in securities, evaluated at their market prices, a total of $2,508,383.49. Since their holdings of the securities of Chain Store Stocks, Inc. cost Atlas Corporation and Chatham Phenix Allied Corporation, as per their books, a total of $2,670,766.73, these corporations suffered a book loss of $162,383.24.[1371]

However, the securities received by Atlas Corporation and Chatham Phenix Allied Corporation from Chain Stores Stocks, Inc. as liquidating dividends included 26,919 shares of the Class B common stock of American Investors, Inc., 72,716 shares of the capital stock of Pacific Eastern Corporation, and 15,647 shares of the first preferred stock of Sterling Securities Corporation. All of these companies were then controlled by Atlas Corporation and were eventually absorbed by Atlas Corporation. These securities had a market value of $583,829.69 and were taken at market value for the purpose of determining the per share distributive interest of the stockholders of Chain Store Stocks, Inc. in the corporate assets. These securities, however, had an

[1364] Id., Commission's Exhibit No. 2001.
[1365] Id., Commission's Exhibit No. 1970.
[1366] Ibid.
[1367] Ibid.
[1368] Id., Commission's Exhibit No. 2001.
[1369] Ibid.
[1370] Id., Commission's Exhibits Nos. 2001, 2033.
[1371] Id., Commission's Exhibit No. 2001.

asset value as at December 31, 1933 of $1,283,857.19, or $700,027.50 in excess of their market value. The asset value of these shares was eventually actually realized by Atlas Corporation. If these securities of Atlas Corporation's controlled investment companies received by Atlas Corporation as a liquidating dividend from Chain Store Stocks, Inc., are taken at their asset value, Atlas Corporation actually derived a profit of $537,644.26 on its investment in the securities of Chain Store Stocks, Inc. On this basis, also, Atlas Corporation actually received as liquidating dividends from Chain Store Stocks, Inc. approximately $14.50 per share of Chain Store Stocks, Inc. held by it. In contrast, minority stockholders of Chain Store Stocks, Inc., who accepted their distributive share of the company's assets in cash rather than in portfolio securities, received $11.32 as a liquidating dividend on each share of their stock.[1372]

5. PAYMENT OF COMPENSATION TO DIRECTORS AND OFFICERS

a. To Induce Transfer of Control

(1) UNIVERSAL SHARES, LTD., AND SUBSIDIARIES—DONALD P. KENYON

In June 1936 Universal Shares, Ltd., a company which had been organized in Delaware in 1933 for the purpose of owning and controlling various investment trusts and companies,[1373] held all of the common stocks of United Sponsors, Inc., and of United Standard Oilshares Corporation.[1374]

United Sponsors, Inc., by virtue of contracts to manage its assets and to distribute its securities, held effective control of Investors Fund of America, Inc.[1375] Investors Fund of America, Inc., had been incorporated in Delaware as an open-end restricted management type investment company.[1376] Its charter limited its permissible investment activities to the purchase only of government securities, other listed securities, bank stocks, and the securities of investment companies whose portfolios were likewise restricted to investments in government securities, other listed securities, or bank stocks.[1377] Although United Sponsors, Inc., had a contract to manage Investors Fund of America, Inc., at an annual compensation equivalent to one-half of one percent of the corporation's assets, it had by a contract delegated this power to Estate Administration, Inc., a management company controlled by individuals who were not dominated by those in control of Universal Shares, Ltd., and its subsidiaries.[1378] Estate Administration, Inc., by agreement with United Sponsors, Inc., was to have exclusive power to select the investments to be made by In-

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[1372] Ibid. For a more detailed discussion of the dissolution of the investment companies acquired by Atlas Corporation, see infra, pp. 1446–57.

[1373] Public Examination, Alpha Shares, Inc., et al., at 19436–7.

[1374] Id., at 19437 and 19443–4; for detailed discussion of the acquisition of these companies by Donald P. Kenyon, see Ch. II of this part of the report, pp. 309 et seq.

[1375] Ibid.

[1376] Id., at 19437–40 and Commission's Exhibits Nos. 3067, 3068.

[1377] Id., at 19435–6, 19444, and Commission's Exhibit No. 3066.

[1378] Id., at 19438–40, 19444–5, and Commission's Exhibit No. 3009.

vestors Fund of America, Inc. No investment could be made by Investors Fund of America, Inc., without the approval of Estate Administration, Inc.[1379] The management of Investors Fund of America, Inc., by Estate Administration, Inc., was stressed in the sales literature used in selling the securities of the investment company.[1380]

By June 1936 about 3,000,000 shares of the stock of Investors Fund of America, Inc., had been sold at prices between 82 cents and $1.20 a share. In June 1936 the corporation had total assets of $2,939,791.[1381]

United Standard Oilshares Corporation, the other subsidiary of Universal Shares, Ltd., held control of United Standard Oilfund of America, Inc.,[1382] an investment company chartered in Delaware to specialize in oil securities, by virtue of contracts to manage and distribute the securities of that corporation. In this case also the management functions of United Standard Oilshares Corporation had been delegated by a contract to Estate Administration, Inc.[1383]

About 240,000 shares of the stock of United Standard Oilfund of America, Inc., had been distributed to the public by June 1936 at prices ranging from $1 to $1.50 a share.[1384] In June 1936 the corporation had total assets of $250,517.61.[1385]

It is obvious from the foregoing recital that control of Universal Shares, Ltd., constituted control of its subsidiary investment companies, Investors Fund of America, Inc., and of United Standard Oilfund of America, Inc. The total assets of these two companies aggregated approximately $3,200,000.

Universal Shares, Ltd., as at June 10, 1936, had outstanding 481,433 shares of 10 cents par value capital stock.[1386] Of these shares, 251,400 shares, a majority of those outstanding, were held in a voting trust of which Gen. John F. O'Ryan, Murray Spies, and Lucian A. Eddy were voting trustees.[1387] The voting trust at this time had approximately eight years to run, and apparently the trustees were empowered to appoint their successors in the event of their resignation. Mr. Spies held none of the shares of Universal Shares, Ltd., or its subsidiaries.[1388] The record does not indicate the holdings, if any, of Mr. Eddy or Gen. O'Ryan. Harold A. Espey, one of the organizers of Universal Shares, Inc., held 127,500 of the outstanding voting trust certificates. Messrs. Spies, Eddy, and Espey, and Gen. O'Ryan were directors and officers of Universal Shares, Ltd., and its subsidiaries.[1389] Mr. Eddy was also president of both Investors Fund of America, Inc., and United Standard Oilfund of America, Inc.

On May 8, 1936, Donald P. Kenyon, who was then actively engaged in purchasing control of investment companies with the purpose of converting their funds to his own use, acquired for the sum of $20,000 all of Mr. Espey's holdings of the voting trust certificates of Universal

[1379] Ibid.
[1380] Id., Commission's Exhibit No. 3072.
[1381] Id., Commission's Exhibit No. 3105.
[1382] Id., at 19443–4, 20078.
[1383] Id., at 19438–40, 19444–5, and Commission's Exhibit No. 3069.
[1384] Id., at 19446–7.
[1385] Id., Commission's Exhibit No. 3105.
[1386] Id., Commission's Exhibit No. 3105 (Exhibit 6A).
[1387] Id., at 19445.
[1388] Id., Commission's Exhibit No. 3073.
[1389] Id., at 19437.

Shares, Ltd. Mr. Espey agreed to sever his connections with Universal Shares, Ltd., and to use his best efforts to obtain the resignation of the voting trustees.[1390] Since the actual asset values of Mr. Espey's stock did not exceed $12,700, Mr. Espey received from Mr. Kenyon approximately $7,300 in excess of the actual value of the shares.

Mr. Kenyon himself, in June 1936, approached the voting trustees who were, by virtue of the voting trust, in actual control of the Universal Shares group of companies, in an effort to secure their resignations. The first of the voting trustees approached by Mr. Kenyon was Gen. O'Ryan. Gen. O'Ryan was induced by Mr. Kenyon to resign as a voting trustee. Whether or not any consideration was paid therefor is not disclosed by the record.

On June 10, 1936, Mr. Kenyon reached an agreement with Murray Spies. Mr. Spies agreed that he would resign as a voting trustee and that he also would secure the resignation of Lucian A. Eddy as a voting trustee. He agreed to secure the appointment of Mr. Kenyon and his nominees as voting trustees. Mr. Spies further agreed to resign as an officer and director of Universal Shares, Ltd., and its subsidiaries. In return for these undertakings on the part of Mr. Spies, Mr. Kenyon agreed to pay Mr. Spies $40,000.[1391] Of this $40,000, Mr. Spies paid Mr. Eddy $2,000.[1392] Mr. Eddy testified that the payment of $40,000 was made to reimburse Mr. Spies and Mr. Eddy for back salary, legal fees, and other unpaid claims which they held against Universal Shares, Ltd., and its subsidiaries.[1393] Nevertheless, the agreement between Mr. Spies and Mr. Kenyon indicates that the payment of $40,000 was intended, in part at least, to compensate Mr. Spies for his future acquiescence in the plans of Mr. Kenyon.[1394] The agreement provided that Mr. Spies would not interfere with Mr. Kenyon's acts in his operations of Universal Shares, Ltd., and its subsidiaries. Mr. Spies agreed also that he would not represent stockholders of any of the companies in any action against Mr. Kenyon. The agreement provided:[1395]

> * * * the Party of the Second Part [Mr. Spies] hereby represents that he will not, at any time hereafter take any steps, directly or indirectly, or perform any act, and will not interfere with the Party of the First Part [Mr. Kenyon] being able to acquire any existing obligations of any of the above companies at such price as said Party of the First Part may be able to acquire same, and that said Party of the Second Part will not in any way interfere with, directly or indirectly, with the business or affairs of any of said corporations so long as the Party of the First Part shall be the owner and in control thereof (interference as herein defined is as follows): "To enter into or take part in the concerns of the party of the first part and the affiliated companies mentioned herein, especially to prevent some act taken or contemplated by the Party of the First Part or the affiliated companies."
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> The Party of the Second Part [Mr. Spies] represents and agrees that he will not accept a retainer to act as the attorney, agent, or representative of any

1390 Id., Commission's Exhibits Nos. 3159, 3160.
1391 Id., at 19452–3 and Commission's Exhibit No. 3073.
1392 Id., at 19453.
1393 Ibid.
1394 Id., Commission's Exhibit No. 3073.
1395 Ibid.

of the stockholders or security holders of the several corporations hereinabove named and/or the affiliate thereunder.

Thus, for a pecuniary consideration Mr. Spies and Mr. Eddy, who owned few, if any, of the shares of Universal Shares, Ltd., and its subsidiary investment companies, turned over the management and control of these companies to Mr. Kenyon. Stockholders who held the real stake in these enterprises were never consulted or informed of the passage of control of their companies to Mr. Kenyon until after the event. In addition, Mr. Spies vacated his position as a fiduciary of the stockholders under an agreement not to oppose any of Mr. Kenyon's future acts.

On June 10, 1936, Mr. Kenyon placed his nominees on the directorates of Universal Shares, Ltd., and its subsidiaries. With the exception of Mr. Eddy, all of the prior directors and officers of the companies resigned.[1396]

Mr. Eddy was retained by Mr. Kenyon as the president and a director of Investors Fund of America, Inc., and of United Standard Oilfund of America, Inc., the investment companies. Mr. Kenyon further agreed to raise Mr. Eddy's aggregate salary from $12,000 per annum to $20,000 per annum.[1397] Mr. Eddy denied, however, that the increase in salary was the reward for his acquiescence in the future plans of Mr. Kenyon, although he conceded that Mr. Kenyon may have had this purpose in mind. Mr. Eddy testified:[1398]

Q. Wouldn't you say that the difference between the $12,000 you were supposed to receive under the former management and the $20,000 you were to receive subsequent to Kenyon's acquisition of control amounted to a consideration to be received by you for your resignation from the various boards in cooperation with Mr. Kenyon?

A. No; I think you could say that that was a consideration received by me for agreeing to stay as president of those two companies.

* * * * * * *

Q. About the time you made arrangements about an increase in salary, did you not?

A. Yes. That was part of the understanding that I was to have an increased salary.

Q. Was the salary unreasonable in the light of the prospects at the time, in your opinion?

A. Not a bit, nor was it unreasonable in my opinion out of proportion to the size of the Fund at that time.

Q. Is it a fact or is it not a fact, this extra salary was to get you to go along and agree to whatever Mr. Kenyon said to do?

A. That may have been in his mind, it certainly was not in mine.

Nevertheless, the record indicates that Mr. Eddy did not too carefully scrutinize the first transactions between Mr. Kenyon and the subsidiaries of Universal Shares, Ltd. Mr. Eddy explained that his suspicions were not aroused because he was very favorably "impressed with his [Mr. Kenyon's] apparent aggressiveness, honesty, and ability,"[1399] and his apparent financial ability to expand the activities of

[1396] Id., at 19453–6 and Commission's Exhibit No. 3074.
[1397] Id., at 19453–4.
[1398] Id., at 19454–5, 19871.
[1399] Id., at 19977.

United Sponsors, Inc., and of United Standard Oilshares Corporation, the sponsoring corporations controlling the underlying investment companies, in the sale of the securities of the investment companies.[1400]

On June 18, 1936, Mr. Kenyon, then in control of Investors Fund of America, Inc., offered to sell the corporation 350 shares of the stock of North Bergen Trust Company at a price of $115 a share, 115,000 shares of the Class AA stock of Monthly Income Shares, Inc., of New Jersey at a price of $1 a share and 135,000 shares of the AA stock of Monthly Income Shares, Inc., of New York at $1 a share.[1401] Mr. Kenyon was acting as agent for the Monthly Income Shares corporations who were the actual sellers of the stock.

Mr. Kenyon had recently acquired control of North Bergen Trust Company, having purchased 1,133 out of 1,500 shares of its stock at a price per share of approximately $44, or for a total of $50,000.[1402] The bank stock had no market, and its book value was $12.30 a share.[1403] Despite the fact that Mr. Eddy knew that Mr. Kenyon was an officer and director of North Bergen Trust Company as well as its controlling stockholder, and despite the fact that he also knew that the shares of the bank's stock offered to Investors Fund of America, Inc., were personally owned by Mr. Kenyon, he assented to the purchase of the stock by the investment company. Mr. Eddy did no more than to take the assurance of Mr. Kenyon that he was not making a profit on the transaction.[1404] In fact, Mr. Kenyon's profit was approximately $25,000.

The Class AA shares of the Monthly Income Shares companies, which were then controlled by Mr. Kenyon, were inferior in preferences to the existing Class A shares of the companies.[1405] Mr. Kenyon, nevertheless, represented to Mr. Eddy that the AA shares were the senior preferred stocks of the Monthly Income Shares corporations.[1406] Since the charter of Investors Fund of America, Inc., restricted its investments in investment company stocks to those of companies whose assets consisted of government and other listed securities, Mr. Kenyon submitted to Mr. Eddy schedules verified only by Charles R. Kenyon, Donald Kenyon's brother, which indicated that both Monthly Income Shares companies held diversified portfolios of listed securities.[1407] In fact, the bulk of the assets of both Monthly Income Shares companies consisted of loans due from Donald Kenyon.[1408]

Mr. Eddy, although he was president of Investors Fund of America, Inc., and the only director of the corporation who was not one of Mr. Kenyon's nominees, approved the purchase of the AA stocks of the Monthly Income Shares companies without making any attempt to verify the relative priorities of the AA stocks and without insist-

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[1400] Ibid.
[1401] Id., at 19457–60, and Commission's Exhibits Nos. 3075, 3076.
[1402] Id., at 19587, 19591.
[1403] Id., at 19585–6.
[1404] Id., at 19457.
[1405] Id., at 19501–2.
[1406] Id., at 19461.
[1407] Id., at 19457–9, 19460, and Commission's Exhibits Nos. 3075, 3076.
[1408] Id., at 19480–1.

ing on an independent audit of the securities held by the Monthly Income Shares companies. Mr. Eddy testified:[1409]

Q. At the time of the purchase just referred to [the North Bergen Trust Co. stock] Mr. Eddy, were you taking orders from Donald P. Kenyon?

A. I wasn't supposed to be taking orders, but he was running the business without consulting me.

* * * * * * *

Q. * * * Mr. Eddy, as I understand it, the company of which you were president bought Monthly Income Shares of New Jersey stock.

A. The preferred stock.

Q. At the time the preferred stock was purchased, did they show you the schedule of securities?

A. Yes.

Q. And that was the one that was signed by Kenyon?

A. That is right.

Q. Did you know where the securities were kept—who had custody of the Monthly Income Share securities?

A. I think at that time he represented that the North Bergen Trust Company was custodian.

Q. Did you call the North Bergen Trust Company and ask them if they were there?

A. We did not.

Q. This schedule which purports to set forth the securities in the portfolio of Monthly Income Shares of New Jersey was not certified by an accountant, was it?

A. No.

Q. It was not certified by the bank?

A. No.

Q. It was just signed by Charles Russel Kenyon?

A. That is right.

Q. And you were president when you bought these just on his original representation that that is what they had?

A. It would appear that way * * *.

* * * * * * *

Q. So they told you they had $75,000 worth of securities. They gave a piece of paper signed by Mr. Kenyon and that was all right with you?

A. Yes.

Q. You didn't call the depository to see if they had them? You had no accountant go over them?

A. No.

Q. Did you call up the accountant for Monthly Income Shares and say, "I have got a certificate here signed by Mr. Kenyon saying there are $75,000 worth of blue chips here, do you know whether he has them?"

A. No; I didn't do that.

* * * * * * *

Q. Mr. Eddy, before you approved of the purchase of the Monthly Income Class AA preferred stock, did you examine the charters of the Monthly Income Shares Corporation?

A. No.

Q. To determine its priority or inferiority in liquidation?

A. No.

[1409] Id., at 19456, 19487–92.

Although Mr. Kenyon secured the approval of Mr. Eddy and of his own nominees on the directorate of Investors Fund of America, Inc., to the purchase of the North Bergen Trust Company and Monthly Income Shares, Inc., stocks, it was necessary to secure also the approval of Estate Administration, Inc. This company, it will be recalled, had exclusive power to select the investments of Investors Fund of America, Inc. Estate Administration, Inc., on inquiry from Mr. Kenyon, refused to approve the purchase of the stocks of Monthly Income Share corporations and of the North Bergen Trust Company.[1410] To overcome this obstacle, Mr. Kenyon paid $20,000 to Estate Administration, Inc., for the cancelation of its management contracts with the investment companies under his control.[1411] Mr. Kenyon then engaged Mr. Edward Embree, an acquaintance, as manager of the funds of Investors Fund of America, Inc.[1412] Mr. Embree's sole function was to approve the purchase by Investors Fund of America, Inc., of the North Bergen Trust Company and the Monthly Income Shares stock.[1413] Mr. Embree received $500 from Mr. Kenyon for his services.[1414]

With the approval of Mr. Embree, Investors Fund of America, Inc., purchased the securities offered to it by Mr. Kenyon. Mr. Eddy, as president of Investors Fund of America, Inc., found nothing suspicious in the removal of Estate Administration, Inc., as the manager of his company's funds, despite the fact, as he testified, that the advice of Estate Administration, Inc., had previously been excellent.[1415]

The $250,000 received by Mr. Kenyon on the sale of the Class AA shares of the Monthly Income Shares corporations was not turned over to these corporations, but was retained by Mr. Kenyon for his own use.[1416] Mr. Eddy testified that he was not aware of this fact at the time of the purchase by Investors Fund of America, Inc., of those securities.[1417]

Mr. Kenyon's next act was to cause the cancelation of the management and distribution agreements between Investors Fund of America, Inc., and United Sponsors, Inc., and between United Standard Oilfund of America, Inc., and United Standard Oilshares Corporation.[1418] About August 1, 1936, Mr. Kenyon caused Investors Fund of America, Inc., to pay to United Sponsors, Inc., the sum of $175,000 for the cancelation of its management and distribution agreement, and caused United Standard Oilfund of America, Inc., to pay to United Standard Oilshares Corporation the sum of $60,000 for the cancelation of its management and distribution agreement.[1419] These

[1410] Id., at 19539.

[1411] Id., at 19659–60.

[1412] Id., at 19510–19 and Commission's Exhibits Nos. 3088 and 3089. Mr. Embree testified that he had been an analyst, statistician, and investment counsel with various organizations since 1914 (id., at 19510).

[1413] Id., at 19510–19 and Commission's Exhibits Nos. 3088, 3089.

[1414] Ibid.

[1415] Id., at 19469.

[1416] Id., at 19608–10.

[1417] Id., at 19470.

[1418] Id., at 19612–3, 19620–1.

[1419] Id., at 19613, 19620–1.

funds, totaling $235,000, were appropriated by Mr. Kenyon to his own use.[1420]

Following the cancelation of these management and distribution contracts in August 1936, Mr. Kenyon caused each of the investment companies to enter into distribution agreements[1421] with Kenyon & Company, Inc., a company recently organized and personally owned by Mr. Kenyon. These agreements permitted Kenyon & Company, Inc., to borrow from Investors Fund of America, Inc., up to $100,000 to be used to maintain a market in the shares of the companies provided they were listed on a securities exchange.[1422] Kenyon & Company, Inc., however, without taking any steps to list the investment companies' shares, borrowed in excess of $50,000 from Investors Fund of America, Inc.[1423] Mr. Eddy testified that he was unaware of these unauthorized borrowings by Kenyon & Co., Inc., from the investment company until well over a month had elapsed after these occurrences. Mr. Eddy also testified that it was his belief that Mr. Kenyon had appropriated these borrowed monies to his own use. He testified that he didn't think "5 cents" was used for the purpose of maintaining a market in the investment companies' stocks.[1424]

By November 1936 the funds which Mr. Kenyon had derived from Investors Fund of America, Inc., including the cost of the stock of the Monthly Income Shares companies, but excluding his profit on the sale of the North Bergen Trust Company stock, totaled $364,000;[1425] his borrowings from United Standard Oilfund of America, Inc., totaled $100,000; and his "borrowings" from United Sponsors, Inc., and United Standard Oilshares Corporation totaled $235,000, the sum these corporations had received for the cancelation of their management and distribution contracts with the investment companies.

Meanwhile, on July 30, 1936, the Attorney General of New York and the Attorney General of New Jersey, acting under the Blue Sky laws of their respective states, had commenced proceedings against the two Monthly Income Shares corporations. The publicity attendant upon these proceedings convinced Mr. Eddy of Mr. Kenyon's lack of integrity.[1426] Mr. Eddy thereafter made some attempts to oust Mr. Kenyon from control of Investors Fund of America, Inc., and from United Standard Oilfund of America, Inc.[1427] In November 1936 the proceedings brought by the Attorney General against the Monthly Income Shares corporations compelled Mr. Kenyon to reach a settlement with Investors Fund of America, Inc.[1428] The proceedings of the Attorney General had disclosed Mr. Kenyon's failure to account to the Monthly Income Shares corporation for the proceeds of the sale of their Class AA stock to Investors Fund of America, Inc. It was, therefore, necessary to restore these shares or the proceeds of their sale to the companies. Mr. Kenyon accord-

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[1420] Id., at 19628–9 and 19636.
[1421] Id., at 19642–3, 19800.
[1422] Id., at 19801–2.
[1423] Id., at 19803–6.
[1424] Id., at 19805–6, 19826.
[1425] Id., at 19828.
[1426] Id., at 19825, 19877.
[1427] Id., at 19875–8.
[1428] Id., at 19822, et seq., and 19827, et seq.

ingly delivered title to certain oil properties in Texas to Investors Fund of America, Inc., in return for the cancelation of his indebtedness to that company and the return of the AA shares of the Monthly Income Shares corporations. Mr. Kenyon apparently also agreed to sever his relationships with Universal Shares, Ltd., and its investment company subsidiaries.[1429]

The oil properties received in cancelation of Mr. Kenyon's total indebtedness of $364,000 to Investors Fund of America, Inc., had an appraised value of $266,000,[1430] although Mr. Eddy contended in his testimony that the properties had an actual value in excess of Mr. Kenyon's indebtedness.[1431] The record, however, does not disclose that Mr. Kenyon in any way discharged his indebtedness to United Sponsors, Inc., United Standard Oilshares Corporation, and United Standard Oilfund of America, Inc. The total indebtedness of Mr. Kenyon to these companies was approximately $335,500 as at November 30, 1936.[1432]

b. To Induce Recommendation of Exchange Offers

(1) ALL AMERICA GENERAL CORPORATION—ATLAS CORPORATION

All America General Corporation, which was the first investment company acquired by Atlas Corporation, was incorporated in Delaware on July 12, 1929, with general power to invest in securities.[1433] The creation of the corporation had been the idea of C. Shelby Carter, an employee of Starring & Co., Incorporated, of which Mason B. Starring was the senior partner. Mr. Carter had obtained a large number of subscriptions to the prospective corporation's shares.[1434]

Starring & Co., Incorporated, became the underwriter of the securities of the corporation, and Mr. Carter, for his efforts in bringing the business to Starring & Co., Incorporated, and for obtaining advance subscribers to the stock of the company, was rewarded with a $25,000 interest in Starring & Co., Incorporated.

Starring & Co., Incorporated, succeeded in selling 201,000 shares of the investment company's stock for which the investment company received $5,025,000, and Starring & Co., Incorporated, received gross underwriting commissions of $402,500. Starring & Co., Incorporated, also received gratis 66,667 warrants to purchase the corporation's stock, most of which were, however, distributed to various dealers and purchasers of the investment company's stock.

By May 1930, after repurchasing and retiring 35,400 of its own shares, the investment company had outstanding 165,600 shares of its capital stock. The net capital contribution made to the corporation for these 165,600 shares was $4,426,673.86.[1435]

Mason B. Starring became a director and the president of the corporation, and Shelby Carter became a director and a vice president

[1429] Id., at 19817, 19824–8.

[1430] Id., at 19829–30.

[1431] Id., at 20081–8.

[1432] For detailed discussion of the amount of the indebtedness of Mr. Kenyon to these companies see Ch. II of this part of the report, pp. 309 et seq.

[1433] Public Examination, All America General Corporation, Commission's Exhibit No. 1634.

[1434] Id., at 15699–701.

[1435] Id., at 15707–8, 15794, and Commission's Exhibit No. 1635.

at a salary of $12,000 a year.[1436] Willard V. King, the father-in-law of Mr. Carter, became the chairman of the board of 21 directors, many of whom were prominent New York financiers.[1437] Mr. King was chairman of the advisory board of Irving Trust Company.[1438] Other directors included: Harold C. Richard, who had been president of The State Bank & Trust Co. of New York City from 1919 to 1929, and was then chairman of the finance committee of Manufacturer's Trust Company; Clarence H. Nichols, a vice president of Federal Light & Traction Company; John W. Campbell, chairman of the board of New York Credit Clearing House; and Richard B. Scandrett, Jr., a vice president of American Gas & Electric Company and a director of Atlas Utilities & Investors Co., Ltd., the Canadian predecessor of Atlas Corporation which was then a subsidiary of Atlas Corporation.[1439] Messrs. Richard, Campbell and Nichols owned, in May 1930, about 33⅓% of the 165,600 outstanding shares of the company.[1440]

Following the market crash of October 1929, there was sharp disagreement among the 21 directors as to the investment policy to be pursued by the corporation.[1441] By May 1930, the asset value of the company's shares was approximately $26 a share.[1442] By June 30, 1930, when Atlas Corporation took over the management of the corporation, the assets of the company totaled $3,149,555.75, or $1,277,-118.11 less than the net contributed capital of $4,426,673.86.[1443] In other words, the assets of the company had depreciated approximately 30% in the seven months of actual operation of the company.[1444] The funds of the company were invested in a diversified portfolio of readily marketable securities.[1445] Messrs. Richard, Nichols, King, and Campbell, together with Scandrett, were apparently in disagreement with the policy of the majority of the directors, headed by Mr. Starring, of remaining fully invested in equity securities.[1446]

At this time, late in April or early in May 1930, Mr. Scandrett discussed with Atlas Corporation officials the possibility of the acquisition of control of All America General Corporation by Atlas Corporation. Mr. Odlum agreed to make an exchange offer of Atlas Corporation's securities for All America General Corporation's securities, and approached Mr. Starring, the president of All America General Corporation, to inquire as to whether or not Mr. Starring would "play ball" with Atlas Corporation. Mr. Starring testified:[1447]

Q. And what was the substance of the conversation?

A. Well, I would say, in a general way, that Mr. Odlum was anxious to acquire control of the trust, and wanted to know whether I would go along and play ball with him and be willing to suggest to the stockholders that they accept

[1436] Id., at 15795.
[1437] Id., at 15807, and *Keane's Manual of Investment Trusts*, 1930, p. 3.
[1438] *Keane's Manual of Investment Trusts*, 1930, p. 3.
[1439] Ibid., p. 5.
[1440] Op. cit. supra. note 1433. Commission's Exhibit No. 1638.
[1441] Id., at 15797.
[1442] Id., at 15710.
[1443] Ibid.
[1444] Ibid.
[1445] Id., at 15708.
[1446] Id., at 15761.
[1447] Id., at 15710–13.

some offer of exchange, and I told him that I—as I recall it, that I naturally, having just started the corporation, would not be in favor of somebody taking it away from me immediately, but if the terms were good enough for the stockholders, I naturally wouldn't oppose anything that was for their benefit.

Q. Did you actively oppose at that time the transfer of the control to Atlas?

A. Mr. Schenker, I did not actively oppose it until the time a definite offer was made to the stockholders.

* * * * * * *

Q. Now, when you told Mr. Odlum that you would not oppose him if the offer was fair, what did he say, do you remember?

A. Well, I don't recall that, Mr. Schenker * * *.

Q. Well, then, what was the result of that conversation? Did he say that he would make an offer and submit an offer to the board?

A. No. The one thing I do remember, Mr. Odlum said, "If you do not want me to do this, I won't do it" and I said "Mr. Odlum, I can't prevent it and if you want to make an offer to stockholders that is to their advantage, it is up to you. Just go ahead and do it, and I have no right to say that you can't do it."

Meanwhile, Mr. Scandrett had succeeded in interesting C. Shelby Carter in the possibilities of an exchange offer by Atlas Corporation.[1448] Mr. Carter, who had been one of the sponsors of the company, had suffered none of the losses suffered by its stockholders. On the contrary, he had received, as a result of his relationship with the company, $12,000 as salary and $25,000 as his interest in Starring & Co., Incorporated.[1449]

As a result of Mr. Carter's conversations with Mr. Scandrett, he was introduced to Mr. Odlum.[1450] As a result of this meeting, Mr. Carter entered into an agreement[1451] with Atlas Corporation wherein he agreed to "use his best efforts" to solicit acceptance of Atlas Corporation exchange offers for the stock and warrants of All America General Corporation. As compensation for his services, and for the loss of his salaried position in All America General Corporation, Atlas Corporation agreed to pay Mr. Carter $75,000 if 66⅔% of the stock and warrants of All America General Corporation were exchanged for Atlas Corporation stock; in the event that less than 66⅔% but more than 51% of the All America General Corporation stock and warrants were exchanged, Mr. Carter was to receive a proportionate deduction from his maximum fee of $75,000. None of the directors of All America General Corporation were aware of the arrangement between Atlas Corporation and Mr. Carter.[1452] Even the directors with whom Atlas Corporation later made independent arrangements for commissions were unaware of Mr. Carter's agreement with Atlas Corporation.[1453]

Mr. Scandrett also had discussions with Messrs. Richard, Nichols, and Campbell, three of the directors of the company, who together owned approximately 33⅓% of its outstanding stock.[1454] As a result

[1448] Id., at 15795.
[1449] Id., at 15794–5.
[1450] Id., at 15797.
[1451] Id., Commission's Exhibit No. 1656–A.
[1452] Id., at 15726–7.
[1453] Id., at 15749.
[1454] Id., at 15731–2.

of these discussions, Mr. Richard testified that the three directors agreed to accept an Atlas Corporation exchange offer of two shares of Atlas Corporation common stock for one share of all America General Corporation common stock with the provision that, in the event that the liquidation value of two shares of Atlas Corporation common stock did not within six months equal at least the then liquidating value of one All America General Corporation share, Atlas Corporation would pay Messrs. Richard, Nichols, and Campbell the difference between the asset value of their Atlas Corporation stock and the liquidating value of their All America General Corporation stock.[1455] Mr. Odlum's recollection, however, was that payments were made to these directors not as a compensation for loss in asset value but as a commission for active help in effecting exchanges. Mr. Odlum also testified that, in his recollection, the agreement to compensate Messrs. Nichols, Campbell, and Richard was made after opposition to the Atlas Corporation exchange offer by a majority of the All America General Corporation directors had developed.[1456]

Having concluded its arrangements with Mr. Carter and having obtained the agreement of Messrs. Richard, Nichols, and Campbell to exchange their shares for Atlas Corporation shares, Atlas Corporation, through Richard B. Scandrett, Jr., on May 8, 1930,[1457] placed before the executive committee of All America General Corporation an offer to exchange two shares of Atlas Corporation common stock for each share of the capital stock of All America General Corporation and one Atlas Corporation warrant for each All America General Corporation warrant. The executive committee referred the matter to the company's board of directors which, on May 13, 1930,[1458] referred the matter to the consideration of a special committee of five directors. Mr. Richard and Mr. King were among the members of this special committee.[1459]

The then asset value of All America General Corporation's stock was approximately $26 a share;[1460] the asset value of two shares of Atlas Corporation common stock was approximately $17.70.[1461] Acceptance of the exchange by All America General Corporation stockholders, therefore, would result in an asset loss to them of $8.30 for each share of their All America General Corporation stock. However, the market value of two shares of Atlas Corporation common was approximately $27.[1462] The market value of one share of All America General Corporation was approximately $21.50.[1463] Stockholders accepting the offer would, therefore, benefit, in terms of market values, to the extent of $5.50[1464] for each share of their All America General Corporation stock. Atlas Corporation, however, was not obligated to make the

[1455] Id., at 15732, 15734.
[1456] See infra.
[1457] Op. cit. supra, note 1433, Commission's Exhibit No. 1646.
[1458] Ibid., and id., Commission's Exhibit No. 1637.
[1459] Id., Commission's Exhibits Nos. 1637, 1639.
[1460] See supra.
[1461] Public Examination, Atlas Corporation, Commission's Exhibit No. 2001 (p. 26).
[1462] Ibid.
[1463] Ibid.
[1464] Ibid.

exchange unless 66⅔% of All America General Corporation stock was obtained by the offer.[1465]

Before the special committee appointed by the board of directors of All America General Corporation to consider the Atlas Corporation's offer had reported on its merits, Atlas Corporation, on May 16, 1930, by a circular letter [1466] made its above offer to the stockholders and warrant holders of All America General Corporation. The offer was to expire on May 31, 1930, subject to possible extensions, but in any event to expire on June 30, 1930. Mr. Carter actually mailed the letters to the All America General Corporation stockholders. He obtained the stockholders' lists from the company's files. He testified: [1467]

Q. Now, it is your recollection, is it, that you took care of the mailing of the formal offer of the exchange or was that done out of the Atlas office?

A. I did that.

Q. You did that?

A. Yes, sir.

Q. From the stockholders' list?

A. Yes, sir.

Q. Who gave you the stockholders' list?

A. It was in the All America office.

Q. Did the board of directors authorize you to use the stockholders' list—to send the exchange offer out?

A. No, sir. I as an officer of the company had a right to look at it whenever I wanted.

Q. Did you tell the board of directors that you were going to take the list and send this offer out?

A. Part of the board of directors signed the letter.

Q. I am talking about the thirteen other members who opposed the offer, did you tell them that you were going to take the stockholders' lists and send that exchange offer out?

A. No, they received it shortly afterward.

Q. But before you sent the letters out, you didn't tell them that you were going to do that, did you?

A. I don't recall telling—any specific time that I told any of them. I may have told some of them; I don't recall that, really.

The circular letter containing the exchange offer stated that the holders of 30% of the All America General Corporation stock and the holders of 50% of its warrants had agreed to accept the Atlas Corporation offer and that Atlas Corporation was extending the same offer to all other stockholders.

The letter further stated that: [1468]

Among the holders who have entered into such an agreement are Messrs. Harold C. Richard, John W. Campbell, and Clarence H. Nichols of the Executive Committee of your Company, and several other directors of your Company, who are the largest individual holders of Common Stock and Option Warrants of your Company.

No mention was made in the offer of the fact that these officers of All America General Corporation were to be compensated for any

[1465] See supra.

[1466] Op. cit. supra, note 1433, Commission's Exhibit No. 1638.

[1467] Id., at 15810–11.

[1468] Id., Commission's Exhibit No. 1638.

loss in liquidating values involved in the exchange. Mr. Richard testified: [1469]

Q. Before the letter of May 16th went out, you had agreed to accept the exchange of two for one as far as the stock was concerned, and an option warrant for one option warrant, as far as your option warrants were concerned?

A. I had.

Q. Now, you, of course, received a copy of the letter of May 16, 1930, making the offer to all of the stockholders, did you not?

A. I probably did.

Q. Do you recall whether this letter was shown to you before it was printed and sent out to see if it was satisfactory to use your name?

A. No; I don't recall.

Q. So that your impression is that you probably received that as a stockholder and the first time that you saw it was when you got the printed form, is that right?

A. Probably. * * *.

Q. Now, the offer was being made to all stockholders, ostensibly on the same basis of two for one, and what was your understanding as to what your arrangement was to be, with the Atlas Corporation, with respect to your 19,000 shares?

A. The Atlas arranged through Mr. Scandrett, I believe, that we would receive the difference in [asset] value of the two stocks at some future date, and he called the attention of Mr. Odlum, that while the stockholders after the exchange could sell the new stock they received for considerably more than their value at that time, of their All America, on the other hand the liquidating value was in the other direction, and the Atlas reply to that was that very shortly it would be the other way around and probably before it could legally take effect it would be the other way around, and so, on the other hand, he said that if it isn't that way, and we don't realize if there is any difference, we will make that good in, I think it was six months time or whatever it was on the basis of that time.

Q. Let me see, if I am accurately recapitulating what your understanding of the understanding was: That you were to get two shares of Atlas Corporation for one of All America General, and one option warrant of Atlas Corporation for one option warrant of all America General, and, of course, there was this disparity in asset value, and you weren't prepared to take it, so was it Mr. Odlum who spoke to you about that?

* * * * * * *

A. I don't know whether they talked it over with me or Mr. Scandrett.

Q. But your understanding of it was that over a prescribed period your recollection being six months, if the asset value of the Atlas Corporation did not equal the asset value of the All America General Corporation at that time, they would pay you in cash the difference?

A. That is right.

* * * * * * *

Q. Now, you notice in this letter of May 16, 1930, it says: "We have agreed to afford you an opportunity to enter into a similar agreement with us to make such an exchange on the same basis * * *." So that the offer to the stockholders was not the same as the offer made to you, was it? You were to get two for one, but if the asset value of the Atlas Corporation did not equal the

[1469] Id., at 15733–6.

asset value of All America General Corporation, they would make the difference up in cash?

A. Yes * * *.

* * * * * * *

Q. So far as you were concerned, you were to get—if the asset value had increased cash payments—was that same condition or promise or understanding or agreement made to the other stockholders?

A. Not that I know of.

Atlas Corporation, however, met with unexpected opposition. On May 20, 1930, Mason B. Starring, the president of All America General Corporation, sent a circular letter [1470] to the stockholders advising them that a special committee of the directors had been constituted to study the Atlas Corporation offer and that it had not yet reported to the board of directors. The letter also stated that a number of the directors had indicated their unwillingness to recommend the exchange offer. The letter further stated that on the basis of the exchange offer now presented, stockholders agreeing to the exchange "will receive two shares of the Atlas Common stock, having an aggregate liquidating value of approximately $17.70 in exchange for the one share of this Company, having an aggregate liquidating value of $26 a share. It is unnecessary to point out that this would be a material sacrifice of book value, amounting to an approximate aggregate of all shares of your company outstanding of $1,370,000." [1471]

On May 22, 1930, Mr. Starring again wrote a circular letter [1472] to the stockholders of his investment corporation informing them that on May 21, 1930, a majority of the board of directors of the corporation (Messrs. Carter, King (Mr. Carter's father-in-law), Campbell, Richard, Nichols, and Scandrett voted in favor of the offer) had voted to reject the Atlas Corporation offer because of the loss in asset value which would be suffered by accepting All America General Corporation stockholders. The letter also stated that "in view of the excellent condition of your company, they [the directors] could see no reason for considering a merger with any other trust." [1473]

The meeting of the board of directors of May 21, 1930, also adopted a resolution which was not communicated to the stockholders, disapproving the "unethical and unauthorized manner" [1474] of certain of its members in attempting to negotiate offers for the capital stock and option warrants of this company prior to the report of the committee of the board of directors duly appointed for that purpose. The resolution obviously referred to the activities of Messrs. Carter, Scandrett, Campbell, Nichols, and Richard. However, as Mr. Starring testified, none of the other directors were aware that these directors were being compensated by Atlas Corporation for their activities.[1475] In fact, the testimony indicates that Mr. Carter was not aware that any other directors were being compensated by Atlas

[1470] Id., Commission's Exhibit No. 1639.

[1471] Ibid.

[1472] Id., Commission's Exhibit No. 1640.

[1473] Ibid.

[1474] Id., at 15717–8.

[1475] Id., at 15726–7.

Corporation,[1476] and that Mr. Richard and his associates were not aware that Mr. Carter was being paid a commission by Atlas Corporation.[1477] The minority stockholders of All America General Corporation were, of course, not informed that several of their directors, who were actively soliciting exchange offers, were being compensated by Atlas Corporation.

In the face of this counter circularization in opposition to the Atlas Corporation offer, Mr. Odlum testified that he entered into the arrangement with Messrs. Nichols, Richard, and Campbell to compensate them against any loss in asset value if they made the exchange. Mr. Odlum stated that, although Mr. Richard and his associates might have understood the remuneration they subsequently received from Atlas Corporation to be compensation for losses in asset values, in Mr. Odlum's own mind they were being compensated for their aid in soliciting and effecting exchange offers. Mr. Odlum testified as follows:[1478]

A. That money was paid to them [Nichols, Campbell, and Richard] for exactly the same thing, for their help, as we paid Shelby Carter for his help. But that arrangement was made after we got into a very open fight, and when it seemed to us that we just couldn't afford to have ourselves come out on the losing end of the fight, and through Scandrett, I am not sure that I ever saw—I know I didn't see all of these men at any time, but I have no recollection of ever having met Mr. Nichols, and I probably met Mr. Richard and Mr. Campbell * * *.

They were large stockholders, and they were directors, and they believed in the exchange, and they were on our side, and we felt that if some active footwork wasn't done, that we might fall short of our goal, and if we fell short of our goal in our first attempt that we could look forward to the future as appearing pretty black in this policy. So we asked them if they would turn in and give active help, and they agreed * * *.

Q. That is a very refreshing, candid bit of testimony, Mr. Odlum.

A. Thank you.

Q. There is no doubt, is there * * * that this was a commission paid to these people to assist you in your exchange program, when you had met this resistance, isn't that so?

A. * * * Now later, when the fight was over, or during the end of it, the suggestion, I believe, was made that they would be quite willing if the asset value of Atlas proved to come up to a certain thing, that they didn't want any pay at all, and I seized on that because I thought it would, too, act as a means of compensating them without paying them any money at all, and it ended up that we did pay them about $160,000, based on some measuring yardstick of asset value, but if you will check you will find, one, that during the period up to April of 1930 the stock market had been rising, and we * * * had leverage in our capital structure, and the All America didn't have any leverage at all, and I believed at that time * * * that within a few months time, given this rise in value, that our Atlas would have picked up so much faster than the All America * * *.

Q. You don't dispute that, regardless of the method of computing what the commission is, this was a commission?

A. To me it was payment for services.

[1476] Id., at 15800.
[1477] Id., at 15749.
[1478] Op. cit. supra, note 1461, at 17765–9.

Q. In connection with the exchange program.

A. And I am not by that denying or refuting * * * anything that Mr. Richard said, because from his standpoint he might have thought it was one thing, and from mine I might have thought that it was another.

Q. You say that this arrangement was made after the consummation of the exchange program, or while it was still in the course of accomplishment, or was it made before the various letters went out?

A. It wasn't made before the letters went out, it was made, I think the arrangement to get their help was made soon after the letters went out and the fight started.

The stockholders of All America General Corporation were placed in the midst of this conflict of two groups of directors. No independent source of advice and counsel was available to them.

Mr. Carter actively solicited exchanges. Telephone and telegraphic inquiries received by All America General Corporation were answered by Mr. Carter with the assistance of Arthur R. Upgren, treasurer of the company, whom Mr. Carter had hired for the purpose.[1479] Mr. Carter's replies to these inquiries were a recommendation to accept the Atlas Corporation offer. However, Mr. Carter never informed inquiring stockholders that he would receive a commission from Atlas Corporation if 51% or more of the All America General Corporation stock was exchanged for Atlas Corporation stock.

Mr. Carter testified concerning his activities on behalf of Atlas Corporation as follows:[1480]

Q. You didn't solicit stockholders personally; isn't that so?

A. Yes.

Q. Did you go on a house to house canvass?

A. No.

* * * * * * *

I solicited lots of stock, and I obtained the signatures of—I can't recall exactly but I certainly obtained the signatures of my father-in-law [Willard King], who was a very substantial stockholder. I think he had nearly 6,000 shares——

Q. Aside from your father-in-law * * * what other stockholders did you contact personally?

A. I can't recall * * * I contacted——

Q. Did you get on the telephone and call up various stockholders?

A. I didn't have to do that. As organizer and an executive officer of this company, I had almost hundreds of calls on this thing after the first letter went out, and people from California sent me telegrams that I had gone out there and interested, and Cincinnati, and I can't remember.

Q. Asking your advice whether to take the exchange?

A. Yes, sir.

Q. And you told them to take it?

A. I told them——

Q. Did you tell them that you were getting $75,000 if you consummated that deal?

A. No, sir. I told them approximately * * * a third of all the outstanding stock were interested in accepting the deal and that I thought that it was to

[1479] Op. cit. supra, note 1433, at 15839.

[1480] Id., at 15812–5.

the best interests of all the stockholders, including themselves, to go into the Atlas Corporation.

Q. But you never mentioned in these telegrams that you sent out that if the deal was consummated that you were going to get $75,000?

A. Not in telegrams; no, and I never mentioned it; no.

Q. And you never mentioned it in any letters that you sent out advising the exchange, did you?

A. I can't recall that I did; no.

* * * * * * *

Q. Let us not deviate as to what your obligation [as a director] was to the stockholders to whom you felt that you owed this obligation. At this time that you represented to these people to accept the exchange offer, you knew that if the exchange offer was effected you would get $75,000 and you didn't mention it to these stockholders, did you?

A. No, sir.

To combat the argument of the majority of the directors of All America General Corporation, that the offer was inequitable from the standpoint of asset values, Mr. Carter prepared a letter to be sent to the stockholders of All America General Corporation. This circular letter [1481] which was sent to the stockholders by Mr. Carter on May 31, 1930, was shown to Mr. Odlum,[1482] and signed by Messrs. King, Richard, Nichols and Campbell, as members of the executive committee of the directors of All America General Corporation.[1483]

On June 4, 1930, Mr. Starring again addressed a letter to the All America General Corporation stockholders advising them that, despite rumors to the contrary, a majority of their board of directors had not approved the Atlas Corporation offer.[1484] The letter also reaffirmed the disapproval of the offer by the majority of the directors.

Nevertheless, the exchange offer was successful. On June 19, 1930, Atlas Corporation had acquired a majority of All America General Corporation's stock.[1485] L. Boyd Hatch, a director and officer of Atlas Corporation, on July 8, 1930 became a director and vice president of All America General Corporation, and the management of the company came under the direction of Atlas Corporation. Mr. Starring, despite his opposition to the Atlas Corporation offer, was retained as president of the corporation until its dissolution in 1933.[1486]

By December 30, 1930, Atlas Corporation had acquired, by exchange of 171,971½ shares of its own stock, 84,727 shares of the stock of All America General Corporation. In addition, Atlas Corporation had acquired, by exchange of 33,688 of its warrants, an equivalent number of the warrants of All America General Corporation.[1487] Including shares of All America General Corporation purchased by Atlas Corporation as well as exchanged shares, Atlas Corporation on December 31, 1930, held 99,296 of the total of 165,600 All America

[1481] Id., Commission's Exhibit No. 1641.

[1482] Id., at 15803–4.

[1483] This letter will be discussed more fully in Sec. IV, infra.

[1484] Op. cit. supra, note 1433, Commission's Exhibit No. 1642.

[1485] Op. cit. supra, note 1461, Commission's Exhibit No. 2001 (p. 20).

[1486] Op. cit. supra, note 1433, Commission's Exhibit No. 1637.

[1487] Op. cit. supra, note 1461, Commission's Exhibit No. 2001 (p. 20).

General Corporation shares then outstanding. Atlas Corporation's holdings constituted 80% of the total outstanding stock.[1488]

On the exchanges, accepting All America General Corporation stockholders suffered a gross loss in asset values of approximately $470,000.[1489] However, of this unrealized gain in asset value to Atlas Corporation, an aggregate of $200,370 was paid to Messrs. Carter, Scandrett, Campbell, Richard, and Nichols as commissions for their efforts in recommending exchange offers. These individuals received the following commissions:[1490]

C. Shelby Carter	$46,000
Richard B. Scandrett	22,700
J. W. Campbell	38,500
Harold C. Richard	77,000
C. H. Nichols	16,170
Total	$200,370

It is obvious that solicitation by Messrs. Richard, Carter, Nichols, Scandrett, and Campbell was of prime importance to the success of Atlas Corporation's acquisition of control of All America General Corporation. These men, as directors of All America General Corporation, presumably had considerable influence upon the attitude of minority stockholders with reference to the exchange offer. Yet, the fact that they were receiving commissions from Atlas Corporation was not disclosed to the stockholders.

Mr. Richard in his testimony conceded that his and his associates' pecuniary interest in the success of the Atlas Corporation exchange offer should have been revealed to the stockholders of his company, and that in situations such as that involved in the exchange offer made by Atlas Corporation for All America General Corporation stock, minority stockholders might well be benefited by the presence of some independent, unbiased agency capable of supervising exchange offers and advising the stockholders as to their merits. He testified:[1491]

Q. And just looking back in retrospect, Mr. Richard, don't you think that the stockholders should have been told about this arrangement that you had with Atlas Corporation? You a former bank president, were a director, and a great many people may have purchased that stock in reliance upon the fact that you were on the Board, isn't that so?

A. No, I don't think so.

Q. I think that you are being modest, Mr. Richard, really.

A. I didn't think at the time I made the sale that I was getting really anything more than otherwise, although it did turn out that way * * * on the other hand in the light of what has gone over the dam, I certainly think that if it had to be done over again, that undoubtedly should have been set forth at the time * * *

* * * * * * *

Q. Do you agree or disagree with that observation that the question of transfer of control of investment trusts from one management to another is of paramount importance to stockholders, particularly minority stockholders, isn't that so?

[1488] Ibid.

[1489] However, by becoming stockholders of Atlas Corporation, exchanging stockholders of All America General Corporation recouped a portion of this gross loss in asset value.

[1490] Id., at 17765 and Commission's Exhibit No. 2001 (p. 22).

[1491] Op. cit. supra, note 1433, at 15747–8, 15753–9.

A. Yes.

Q A person may be perfectly willing to turn his money over to H. C. Richard who was president of the State Bank at one time, and not willing to have his money handled by John Doe, isn't that so?

A. Yes.

* * * * * * *

Q. Now, ostensibly, at least, all of the stockholders are represented by the board of directors; isn't that so?

A. Yes.

Q. That is the way the inarticulate stockholders are supposed to be articulate; his mouthpiece is his Board of Directors, to whom he entrusts his interests; isn't that so?

A. Yes.

* * * * * * *

Q. Now, let us see what the situation was in this case here. The majority of the board opposed the offering; isn't that so?

A. Yes.

Q. They thought it was to the best interests of the stockholders not to give up at that time at least $26 of asset value for $17.70 of asset value.

A. I don't know about those figures.

Q. But they said they weren't prepared to recommend to their stockholders to accede to an offer which had a disparity in asset value; isn't that so?

A. That was their statement.

Q. You didn't accord with that judgment, I assume; you were in——

A. I was very much opposed to the method in which the majority of the board was carrying on, and I felt that the stockholders and myself would be very much better off if we had this other management.

Q. But that was your personal opinion?

A. That was my opinion as a director of the company.

* * * * * * *

Q. You were a substantial stockholder and Mr. Campbell was a substantial stockholder and Mr. Nichols was a substantial stockholder; and I assume that Mr. Scandrett had stock, or don't you know?

A. Yes.

Q. So that the stockholder finds himself in a position where the majority of the board says it is against your interests to effect an exchange, and other directors who happen to be majority stockholders say "we want to make this exchange" and tell you that "we are going to make it."

A. Yes.

Q. That left the stockholder in a position of not having any independent agency advising him; isn't that so?

A. Yes.

Q. Mason B. Starring may have had some pecuniary interest in not surrendering control by virtue of his management?

A. Yes, sir.

Q. You had a pecuniary interest * * *.

A. Yes.

Q. So that on the board were two groups advising the stockholders, and there is not any doubt that there was the pecuniary interest involved in the advice; isn't that so?

A. Well, we naturally would advise the same way that would benefit ourselves or would benefit the other stockholders.

Q. So that you could get your two Atlas for one of All America and a possible cash payment—you wouldn't get that unless the other people turned in their stock; isn't that so?

A. Yes.

* * * * * * *

Q. Don't you think that there ought to be possibly some independent agency, governmental or otherwise, who would be authorized to scrutinize these plans and offer suggestions or criticisms so that the minority stockholder who finds himself in a position as he found himself in All America would get some independent judgment on those situations?

A. I think something like that might be a very good idea * * *.

Atlas Corporation, in addition to acquiring shares under the exchange offer, also purchased All America General Corporation shares in the open market.[1492] In open market transactions, Atlas Corporation was virtually the only bidder. Upon taking over the management of All America General Corporation in July 1930, Atlas Corporation had terminated All America General Corporation's policy of buying in its own shares.

By May 29, 1931, Atlas Corporation had acquired by purchase and exchange 105,133 shares of All America General Corporation stock and 49,514 of its warrants. On that day Atlas Corporation sold for $1,486,246.43 all of its then holdings of All America General Corporation's securities to Allied Atlas Corporation,[1493] the former Exide Securities Corporation, control of which was acquired by Atlas Corporation immediately after it had acquired control of All America General Corporation.[1494] Thereafter, Atlas Corporation transferred all of the shares and warrants which it subsequently acquired in 1931 to Allied Atlas Corporation.[1495] By December 31, 1931, Atlas Corporation had disposed of all its securities of All America General Corporation to Allied Atlas Corporation for a total price of $1,701,243.32.[1496] This price represented approximately one-third of the total assets of Allied Atlas Corporation.

By December 31, 1931, Allied Atlas Corporation owned 68% of the stock of All America General Corporation and 73% of its warrants.[1497]

On June 4, 1932, Atlas Corporation made simultaneous offers to exchange its shares for the shares of 12 investment companies then under its control. Included in these offers was an offer of 1.4 shares of Atlas Corporation common stock for each share of All America General Corporation stock then outstanding. The then asset value of the 1.4 Atlas Corporation shares offered was $4.16. The asset value of All America General Corporation's stock was $7.65 a share, computed on the basis of market values of its portfolio. However, if the portfolio holdings of All America General Corporation in Atlas Corporation's controlled investment companies were taken at their asset values rather than their market values, the asset value of All America General Corporation shares would have been considerably greater than $7.65 a share. The exchange involved a gross loss in asset values to

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[1492] Op. cit. supra, note 1461, Commission's Exhibit No. 2001 (p. 21).

[1493] Ibid.

[1494] Ibid.

[1495] Ibid.

[1496] Ibid.

[1497] Ibid.

accepting All America General Corporation stockholders of $3.49 a share of their stock on the basis of an asset value of All America General Corporation stock of $4.16 a share. The market value of the 1.4 Atlas Corporation shares offered exceeded the market value of a share of All America General Corporation by 50 cents.[1498]

As a result of the offer, Atlas Corporation acquired 25,790 shares of All America General Corporation stock. The gross loss in asset value to All America General Corporation stockholders who accepted the offer was approximately $86,000.[1499]

During 1932 and 1933 Atlas Corporation and its subsidiaries continued their purchases of All America General Corporation stock and warrants. On December 27, 1933, the date on which All America General Corporation was dissolved, Atlas Corporation and its subsidiaries held 164,113 shares of All America General Corporation's stock.[1500] Minority stockholders held 1,487 shares, or less than 1%, of the total shares outstanding.[1501]

The book cost of the investment of Atlas Corporation and its subsidiaries in the shares and warrants of All America General Corporation was approximately $3,048,000.[1502] In computing this cost, Atlas Corporation valued the shares it acquired by exchange at their asset values. If, however, the excess asset value accruing to Atlas Corporation on the exchanges, which totaled approximtely $555,000, is deducted and there is included the amounts paid as commissions to Messrs. Carter, Scandrett, Campbell, Richard, and Nichols, totaling approximately $200,000, the actual cost of the investment by Atlas Corporation and its subsidiaries in All America General Corporation was approximately $2,693,000.

On this investment Atlas Corporation and its subsidiaries received liquidating dividends in cash and securities valued at their market value totaling approximately $1,999,000.[1503] However, if the securities of the Atlas Corporation controlled investment companies in the portfolio of All America General Corporation are valued not at their market values but at their asset values, the actual liquidating dividends received by Atlas Corporation and its subsidiaries totaled approximately $2,872,000. Measuring this actual return against cost, the profit on their investment in All America General Corporation to Atlas Corporation and its subsidiaries was approximately $179,000. Mr. Odlum testified, however, that this profit was consumed by expenses of acquisition and that actually Atlas Corporation had lost money on its investment in All America General Corporation.[1504]

[1498] Id., Commission's Exhibits Nos. 1970, 2001 (pp. 25–26). The asset value of the common stock of Atlas Corporation was $2.97 a share on June 4, 1932. However, the exchange offer stated that the asset value of the common stock of Atlas Corporation would be $7.30 a share if all of the stockholders of its controlled investment companies accepted its exchange offers.

[1499] Id., Commission's Exhibit No. 2001 (p. 28). See, however, note 1489, supra.

[1500] Ibid.

[1501] Ibid.

[1502] Ibid.

[1503] Ibid.

[1504] Id., at 17837–9.

(2) POWER AND LIGHT SECURITIES TRUST—ATLAS CORPORATION

Power and Light Securities Trust was created under an indenture of trust,[1505] dated January 21, 1926. In its form of organization it was a common law trust of the type commonly referred to as a "Massachusetts" trust. Hale, Waters & Company, Boston investment bankers, sponsored the trust,[1506] and at all times prior to the shift in control to Atlas Corporation two of the three trustees administering the trust were partners in the firm of Hale, Waters & Company.[1507] The trust indenture authorized the trustees or organizations with which they were connected to deal with the trust as freely as if they were not trustees, provided that disinterested trustees approved the transactions.[1508]

The trustees were authorized to deal generally in securities, but, as the name of the trust implied, investments were to be made predominantly in the securities of utility companies. In fact, the only trustee not associated with Hale, Waters & Company was Frederick A. Farrar, a director and vice president of Electric Bond & Share Company.[1509]

The trustees were authorized to issue certificates of beneficial interest and option warrants to purchase, at a price of $75 a certificate, certificates of beneficial interest at any time during the continuance of the trust. Early in 1926, Hale, Waters & Company sold to the public 40,000 units of the trust's securities, each unit consisting of a certificate of beneficial interest in the trust and an option warrant to purchase an additional certificate of beneficial interest at a price of $75 at any time during the continuance of the trust.[1510] On the sale of these units Hale, Waters & Company received total gross commissions of approximately $80,000.[1511]

In addition, Hale, Waters & Company received from the trust, as compensation for their services in organizing it and as compensation for all future management services,[1512] warrants to purchase at $75 a certificate 40,000 certificates of beneficial interest in the trust exercisable at any time during the continuance of the trust.[1513]

In 1928 and 1929, additional certificates were offered to the public. In all, a total of 81,607 certificates were issued by the trust.[1514] On these sales the trust received a total of $4,266,616.90.[1515] However, following the securities market collapse of 1929, the trust embarked on a policy of repurchasing its own shares. During the period February 3, 1930, to December 23, 1930, the trust purchased 18,040 of its own shares at a total cost of $1,011,567.50.[1516]

[1505] Id., Commission's Exhibit No. 1971.

[1506] Id., at 17840.

[1507] Ibid.

[1508] Id., Commission's Exhibit No. 1971.

[1509] Id., at 17847.

[1510] Reply to the Commission's questionnaire for Power and Light Securities Trust, Pt. I, Exhibit 3–B.

[1511] Op. cit. supra, note 1461, Commission's Exhibit No. 2003.

[1512] Id., at 17842, 17848.

[1513] Id., Commission's Exhibit No. 1971.

[1514] Derived from supplementary information supplied the Commission for Power and Light Securities Trust.

[1515] Op. cit. supra, note 1461, at 17857.

[1516] Id., at 17858 and Commission's Exhibit No. 2003.

As at February 28, 1931, the trust had outstanding 63,567 certificates of beneficial interest and warrants to purchase 79,485 certificates of beneficial interest.[1517] Hale, Waters & Company, as at January 31, 1931, held 33,681 of these warrants[1518] which represented the balance of the 40,000 warrants issued to them in 1926 as compensation for management. Hale, Waters & Company apparently did not own a substantial amount of the outstanding certificates of beneficial interest of the trust.

After giving effect to repurchases of certificates and cash dividends paid, the total capital contributed to the enterprise, as at January 31, 1931, was $2,973,663.28.[1519] As at January 31, 1931, net assets of the trust totaled $2,609,912.09,[1520] so that there had been suffered a total depreciation on the net contributed capital of $363,751.19. This shrinkage constituted 12.2% of the net capital contributed to the trust.

Of this total shrinkage of $363,751.19, the largest single loss was in the preferred stock of Thompson's Spa, Inc., a corporation operating a chain of confectionery stores in Boston.[1521] This stock had been sold to the trust by Hale, Waters & Company.[1522] In January 1929, Hale, Waters & Company had offered to the public 35,000 units of Thompson's Spa, Inc. securities at $103.50 a unit, each unit consisting of one share of preferred stock and one share of common stock.[1523] On January 4, 1929, Power and Light Securities Trust had purchased from Hale, Waters & Company 500 of these units for $51,775.[1524]

As at December 31, 1929, the current liabilities of Thompson's Spa, Inc., exceeded its current assets by $56,402.[1525] The Thompson's Spa, Inc., stock had no market, it was not listed on any exchange, nor was it regularly quoted over-the-counter. Nevertheless, on August 6, 1930, Hale, Waters & Company, "probably"[1526] as principal, sold to Power and Light Securities Trust 3,000 shares of the preferred stock of Thompson's Spa, Inc., for a total price of $240,000. Thus, as at February 28, 1931, the trust had invested a total of approximately $290,000 in the securities of Thompson's Spa, Inc., all of which had been purchased from Hale, Waters & Company. The investment at cost represented approximately 10% of the total assets of the corporation as at February 28, 1931.[1527] As at February 28, 1931, the market value of this investment was $213,000,[1528] so that the trust suffered at that time an unrealized loss on the investment of $77,000. After Atlas Corporation had acquired control of Power and Light Securities Trust, it sold in 1932 the securities of Thompson's Spa, Inc., on the market for a realized loss, as against actual cost of the securities, of $218,000.[1529] This loss was directly attributable to the interdealing be-

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[1517] Id., Commission's Exhibit No. 2043.
[1518] Id., Commission's Exhibits Nos. 1973, 2001 (p. 47).
[1519] Id., Commission's Exhibit No. 1973.
[1520] Ibid.
[1521] Id., at 17843.
[1522] Ibid.
[1523] *Moody's Manual of Investments, Industrials,* 1930, p. 1571.
[1524] Op. cit. supra, note 1461, Commission's Exhibit No. 1973.
[1525] *Moody's Manual of Investments, Industrials,* 1930, p. 1571.
[1526] Op. cit. supra, note 1461, at 17842–3.
[1527] Id., Commission's Exhibit No. 1973.
[1528] Id., Commission's Exhibit No. 2043.
[1529] Id., Commission's Exhibit No. 1973.

tween Hale, Waters & Company and Power and Light Securities Trust. In addition, the investment was at variance with the announced policy of the corporation to invest primarily in utility securities.[1530]

Despite the fact that the trust had suffered, as at February 28, 1931, a shrinkage of only 12% of its net contributed capital, James P. Hale, the senior partner of Hale, Waters & Company, had come to the conclusion that utility securities were "dropping fast,"[1531] and that Power and Light Securities Trust's assets were "fading fast."[1532] Mr. Hale further stated that "there wasn't much fun in running a trust in those days."[1533] Accordingly, Mr. Hale negotiated with Atlas Corporation with the purpose of inducing Atlas Corporation to make an exchange offer of its securities for the securities of Power and Light Securities Trust. On February 6, 1931, an agreement was reached with Atlas Corporation under the terms of which Hale, Waters & Company were to receive certain commissions for their aid in soliciting exchange offers.[1534] This agreement will be more fully described later.

As at February 28, 1931, the asset value of Power and Light Securities Trust certificates was approximately $47.42 a certificate.[1535] If the trust had at that time been dissolved, each certificate holder could have purchased approximately nine shares of Atlas Corporation common stock (which was selling in the market at approximately $5.125 a share) with his distributive share of the assets, or in the alternative, could have purchased 1.18 shares of Atlas Corporation preference stock which then had a market value of approximately $40 a share.[1536] As will be indicated hereafter, the exchange offer of Atlas Corporation securities involved an offer of either only seven shares of Atlas Corporation common stock for each certificate of Power and Light Securities Trust or, in the alternative, four-fifths of a share of Atlas Corporation preference stock for each certificate of Power and Light Securities Trust.[1537]

James P. Hale testified that he had given some thought to the dissolution of Power and Light Securities Trust, but that he deemed the Atlas Corporation exchange offer more advantageous to Power and Light Securities Trust certificate holders. He also testified that it was his understanding that, if the Atlas Corporation exchange offer was successful, it was the plan of Atlas Corporation to dissolve the company. Mr. Hale testified:[1538]

Q. Now, you thought, I assume, that this would be a good exchange if the Power and Light beneficial certificate holders became holders of Atlas Corporation [stock]?

A. I did.

Q. Now, did it occur to you at that time that you, as trustee, could have submitted to the beneficial certificate holders the proposition that the trust be liquidated and then send these people a nice, polite letter saying that "we recommend

[1530] Id., at 17845.
[1531] Id., at 17857–9.
[1532] Ibid.
[1533] Id., at 17846.
[1534] Id., Commission's Exhibit No. 1973.
[1535] Id., Commission's Exhibit No. 2001 (p. 48).
[1536] Ibid.
[1537] Id., Commission's Exhibits Nos. 1970 and 2001 (pp. 48–9).
[1538] Id., at 17848–51.

that you buy Atlas Corporation stock because we think Mr. Odlum's management would be beneficial to you"; did you give any thought to that?

A. Oh, yes.

Q. And what difficulties did you find with that?

A. I felt that my honest advice to the beneficial holders would be that the Atlas exchange was far better than liquidation.

Q. Now, the Power and Light certificate holders were going to get Atlas stock, isn't that so?

A. Yes.

Q. And if an individual had cash he could go out and buy Atlas stock; isn't that so?

A. That is right.

Q. Now, if you liquidated the trust and gave the security holder his full asset value he could buy more shares of Atlas Corporation than he was getting in the exchange, could he not?

A. But you don't know at what price we would have finally liquidated it at.

Q. Do you mean to say that the figures you were giving to your stockholders as to the asset value of the trust at the time you were sending out reports was not accurate?

A. It was accurate; but, on the other hand, on a certain night you can asset a trust with the last market of the day, but to sell two and a half or three million dollars of that stuff in the next day or two doesn't prove you are going to get that figure.

Q. In computing the asset value in which you had a special situation, but you had no special situation; you had a diversified portfolio?

A. Yes, sir.

Q. Were they all listed securities?

A. Nearly all.

Q. Were they all fairly active stocks?

A. Fairly so.

Q. And you had in the entire portfolio at that time approximately $3,000,000?

A. That is right.

Q. And there was no law that said you had to liquidate over night?

A. But everybody else was liquidating over night at that time.

Q. Then the only thing you are telling me is that when you told the stockholders that the asset value was so much, it wasn't really telling them that it was so much?

A. No; our judgment was that it was a better thing for the stockholders to do to accept the Atlas offer than to liquidate.

Q. I don't dispute that, Mr. Hale. The only thing I am trying to ascertain is what impelled you to that honest judgment that it was not advisable to liquidate the trust, give the individuals the cash, and put them in the position to buy more Atlas Corporation stock in the open market than they were getting on the exchange offer. You don't dispute that that is the fact?

A. If you are going to sell on one hand and buy on the other, you move both markets, Mr. Schenker, but if the deal is offered at a fixed market where the trust beneficiary had three weeks to think it over and to have it explained to them, you have a more concrete proposition; and that applied to us.

Q. Now, did you submit to the stockholders the possibility of liquidation?

A. No.

The agreement between Atlas Corporation and Hale, Waters & Company, dated February 6, 1931,[1539] was, however, far more pecu-

[1539] Id., Commission's Exhibit No. 1973.

niarily advantageous to Hale, Waters & Company than a dissolution of Power and Light Securities Trust would have been. Under this agreement, Atlas Corporation agreed to offer to Power and Light Securities Trust certificate holders either (a) four-fifths of a share of Atlas Corporation preference stock; or (b) a unit consisting of two-thirds of a share of Atlas Corporation preference stock and one share of Atlas Corporation common stock; or (c) seven shares of Atlas Corporation common stock for each Power and Light Securities Trust certificate.[1540] In addition, Atlas Corporation offered to exchange 1¼ of its warrants for each warrant of Power and Light Securities Trust. The first alternative offer involved a gain, in terms of market values, to Power and Light Securities Trust certificate holders of $1 per certificate; however, acceptance of the offer involved a loss in assets for each Power and Light Securities Trust certificate of approximately $7.42.[1541] The second alternative offer involved a market-value gain of 75 cents to Power and Light Securities Trust certificate holders but a gross asset loss to certificate holders of $8.59 per certificate exchanged. The third alternative offer involved a market-value gain to Power and Light Securities Trust certificate holders of $4.49 but an asset loss for Power and Light Securities Trust certificates of $8.92. The exchange of warrants was favorable to Power and Light Securities Trust warrant holders, since the Atlas Corporation warrants received had a market value of approximately $2.35 as against the market price of $2 then existing for Power and Light Securities Trust warrants.[1542] Atlas Corporation had the privilege of canceling all offers unless at least 51% of the Power and Light Securities Trust certificates and warrants were exchanged. Hale, Waters & Company agreed to "use their best efforts" to obtain the acceptance of the above offer "by holders of certificates and options to purchase shares of Power and Light Securities Trust to the end that as many shares and options to purchase shares of Power and Light Securities Trust as is possible shall be deposited thereunder," and further agreed to address a circular letter to all warrant and certificate holders of Power and Light Securities Trust, recommending acceptance of the Atlas Corporation exchange offer. As consideration for these services to be performed by Hale, Waters & Company, and provided that at least 51% of the security holders of Power and Light Securities Trust accepted the offer, Atlas Corporation agreed to pay Hale, Waters & Company $200,000 in cash and an additional $1 for each Power and Light Securities Trust certificate exchanged for Atlas Corporation's securities. Atlas Corporation further agreed to purchase Hale, Waters & Company's holdings of Power and Light Securities Trust warrants at a price in cash of $2 a warrant.[1543]

The pecuniary interest of Hale, Waters & Company in the success of these exchange offers by Atlas Corporation is obvious. Mr. Hale testified:[1544]

Q. * * * How much was supposed to be deposited—you were only to get the $200,000 if a certain percentage was deposited?

[1540] Ibid., and id., Commission's Exhibits Nos. 1970, 2001 (p. 47).

[1541] Id., Commission's Exhibit No. 2001 (p. 48).

[1542] Ibid.

[1543] Id., Commission's Exhibit No. 1973.

[1544] Id., at 17854–5.

A. Yes.

Q. Therefore it was to your pecuniary interest, was it not, Mr. Hale, that 51% of the certificate holders accept that offer?

A. I did the whole thing for the interest of the beneficial holders.

Q. I understand that, but if 51% of the certificate holders didn't turn in their stock, you would have been out $200,000; isn't that so?

A. I don't know; it may have cost us that much to get the stock in.

Q. I will come to the cost in a moment; but the fact is that unless the 51% went in you were out $200,000, and in addition to that you were out the one dollar a share that you would have gotten for every exchange that was accepted?

A. Yes.

Mr. Odlum, when examined as to the purpose of the agreement to compensate Hale, Waters & Company for their services in advocating the exchange, testified: [1545]

Q. Now, as you said yesterday, Mr. Odlum, that you resented the inference which might be drawn from my interrogation that these various compensations made to the officers and directors, and the influential insiders, and you don't dispute that Hale, Waters were influential in this picture?

A. No.

Q. And that the payments were made to obtain the active cooperation of the sponsors in connection with the exchange program. Wasn't this a case where at least the two hundred thousand dollars was paid with the specific purpose of getting that cooperation?

A. I don't believe so. I don't know how the two came together.

Q. I will read you from the minutes of the Atlas Corporation of February 6, 1931, as follows:

"The Chairman"—that is yourself—"presented to the Board a copy of an agreement dated February 6, 1931, between this corporation and Hale, Waters & Company, providing, among other things, that in consideration of Hale, Waters & Company using their best efforts to induce the deposits of shares and options to purchase shares of Power and Light Securities Trust, under and pursuant to the terms of the above agreement, this corporation would pay to Hale, Waters (A) two hundred thousand dollars and (B) one dollar for each share"—and then, of course, you had the option warrants—"and two dollars for each share purchasable under options to be delivered to Hale, Waters & Company to this corporation without the deposit of said options under said offer."

I mean the minutes at least give the indication that that was the purpose.

A. What is your question again?

Q. Wasn't this a case where the payment of at least two hundred thousand dollars was made with the specific purpose and intent to get the active cooperation in the exchange program of the influence of this firm?

A. It was paid to them for * * * the option warrants that they had and the services that they would perform in placing this before the stockholders and getting the stock exchanged.

Mr. Odlum further testified with respect to exchange offers in which sponsors of a company had a pecuniary interest in the success of the offers: [1546]

[1545] Id., at 17870–1.

[1546] Id., at 17873–4, 17877–8.

Q. So that your duty was to your stockholders to get the best buy that you could buy them; isn't that so?

A. Yes; the best buy that I could get with a long range policy.

Q. On the other hand, it was Mr. Hale's duty to get the best buy for his certificate holders?

A. That is true.

Q. But unfortunately, or at least theoretically, that situation was complicated by the fact that Mr. Hale was going to get two hundred thousand dollars if the deal went through; isn't that so?

A. He was going to get two hundred thousand plus.

Q. Yes; and he ultimately got over $333,000. Of course, that figure included his option warrants which he turned in, so that at least superficially Mr. Hale was in a position where he had a decided conflict of interest. If he insisted upon what he thought was the best buy for his clients and that deal didn't meet with your ideas of an equitable deal under the circumstances, there would be no deal; isn't that so?

A. But my recollection is that it is true in that, and I believe in every other case, that the question of what Mr. Hale's firm was to receive for working on the exchange program was never discussed until after the trade on the basis of exchange had been arrived at.

* * * * * * *

A. I see this difficulty, and I am not saying that the difficulty surmounts the advantages, that when I am dealing with Mr. Hale I am responsible to my shareholders and Mr. Hale is responsible to his clients, and we are legally responsible, but if we have to go to the highest public officer in the country, so that he substitutes his decision for our business, he is a man dealing with the situation, with responsibility to no one, and it would be likely to cause many complications and bad features, and it has many good features too.

On February 6, 1931, Atlas Corporation, in a circular letter to the certificate and warrant holders of Power and Light Securities Trust, made the alternative exchange offers which have been described. Accompanying this letter was one on the stationery of Hale, Waters & Company, recommending acceptance of the Atlas Corporation exchange offers. The letter from Hale, Waters & Company also stated: [1547]

Hale, Waters & Company, two of the partners of which are trustees, in consideration for arranging this offer and for services rendered in connection therewith, will obtain independent compensation in which the partners who are trustees will share. None of this compensation is, of course, to be paid by the shareholders or option holders of Power and Light Securities Trust.

The security holders of Power and Light Securities Trust were therefore informed that Hale, Waters & Company was being paid for its services. The letter did not, however, indicate the precise terms of the agreement between Atlas Corporation and Hale, Waters & Company, nor did it reveal that Hale, Waters & Company were obtaining, for their Power and Light Securities Trust warrants, cash rather than Atlas Corporation warrants. Realistically, moreover, the commissions were paid by Power and Light Securities Trust certificate holders, since these commissions were paid from the ultimate gain in asset values realized by Atlas Corporation as the result of its acquisition of Power and Light Securities Trust.

[1547] Id., Commission's Exhibit No. 1973.

As a result of this exchange offer, Atlas Corporation acquired 55,779 certificates and 41,534 option warrants of Power and Light Securities Trust. On the exchange, accepting Power and Light Securities Trust certificate holders suffered a gross loss in asset values of approximately $480,000.[1548] Atlas Corporation paid a total of $323,945 to Hale, Waters & Company as commissions and as consideration for the purchase from Hale, Waters & Company of 33,681 Power and Light Securities Trust option warrants.[1549]

In addition to the certificates of Power and Light Securities Trust acquired by exchange offer, Atlas Corporation purchased 4,941 certificates at a total cost of $171,885.89. The average price paid for these certificates was approximately $35, or $12 less than the asset value of such certificates.[1550]

L. Boyd Hatch and Oswald L. Johnston, both of whom were Atlas Corporation directors, became two of the three trustees of Power and Light Securities Trust.[1551] James P. Hale, of Hale, Waters & Company continued as the third trustee.

By June 3, 1931, Atlas Corporation held 60,721 certificates of Power and Light Securities Trust, or approximately 95% of the total certificates outstanding. Atlas Corporation also held 75,237 of the outstanding option warrants of Power and Light Securities Trust. These holdings constituted 95% of the outstanding warrants.[1552] On June 3, 1931, all of the assets of Power and Light Securities Trust were conveyed to General Empire Corporation in exchange for General Empire Corporation shares, and Power and Light Securities Trust was dissolved.[1553] The transaction by which Atlas Corporation acquired control of General Empire Corporation has already been described.[1554]

6. PURCHASE OF CONTROL WITH ACQUIRED COMPANY'S OWN FUNDS

The techniques for acquiring control of investment companies which have already been described and illustrated do not necessarily require the use of any personal funds by the acquiring individuals. Some individuals have obtained control of investment companies by the use of the assets of the acquired investment companies themselves. Borrowed funds have been used to acquire control of investment companies, and the loans have been repaid by the liquidation of the assets of the acquired company or companies and the appropriation [1555] by the new managers of the proceeds of such liquidation and the application of these proceeds to the repayment of the loans made to acquire control of the company.

[1548] Id., Commission's Exhibit No. 2001 (p. 50). However, exchanging certificate holders by becoming stockholders of Atlas Corporation recouped a portion of this loss in asset values.

[1549] Ibid.

[1550] Ibid.

[1551] Id., Commission's Exhibit No. 1973.

[1552] Id., Commission's Exhibit No. 2001.

[1553] Ibid.

[1554] See supra, pp. 1258–70.

[1555] In some cases the appropriated assets of the investment companies have been replaced with securities of personal holding companies owned by new managements. Compare the activities of the Fiscal Management group discussed, supra, pp. 1072–5.

In no small measure the harmful results to the stockholders of investment companies, control of which have been acquired in this manner, were the consequence of the failure of the prior controlling group to make an adequate investigation of the financial status, character and ability of the individuals to whom they relinquished control of these companies for an attractive consideration. Moreover, not infrequently the old managements surrendered control of their companies to new groups even before they had received the purchase price for the control of their companies. An opportunity was thus afforded to the new group to derive the purchase price for control from the acquired investment company itself.[1556] By these methods control of large aggregates of liquid assets can be acquired without any personal expenditure upon the part of the new controlling interests.[1557]

The power of a controlling group to rearrange the capital structure of controlled investment companies also provides a means by which the investment company's own assets can be, in effect, utilized to purchase control of the company. An effective device for this purpose is the power of a controlling individual to cause the investment company to repurchase its own shares.

a. International Equities Corporation

The acquisition by Ernest B. Warriner of control of International Equities Corporation is illustrative of this technique.

On November 5, 1935, Ernest B. Warriner, at a cost of $185,070.75, purchased 11,049 shares of the Class A and 4,586 shares of the Class B stock of International Equities Corporation [1558] which then had assets of approximately $1,165,000.[1559] These shares represented 23% of the voting power of International Equities Corporation.[1560] To consummate this purchase Mr. Warriner borrowed $50,000 from Underwriters & Participations, Inc., an investment company which he controlled,[1561] and $139,000 from Delaware Trading Corporation [1562] on

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[1556] Compare the acquisition of control of North and South American Corporation and of Insuranshares Corporation of Delaware by Insurance Equities Corporation, discussed supra, pp. 1179–1225.

[1557] For example, as has already been described, by the use of borrowed funds which were repaid by the use of the assets of the very investment companies whose control they acquired, the Fiscal Management group, who were without substantial funds, were enabled to acquire control of four investment companies with aggregate assets of approximately $12,300,000. By similar methods Insurance Equities Corporation, which possessed no substantial assets, acquired control of the approximately $5,000,000 of assets held by Insuranshares Corporation of Delaware and North and South American Corporation. See supra, pp. 1179–1225. Compare also the tactics by which David Milton and his associates acquired control of Atlantic and Pacific International Corporation (ibid.), and the methods used by Wallace Groves to acquire control of Chain and General Equities, Inc., Interstate Equities Corporation, and Yosemite Holding Corporation, discussed supra, pp. 1031–9.

[1558] Public Examination, General Investment Corporation, Commission's Exhibit No. 1577.

[1559] *Moody's Manual of Investments, Banks, etc.,* 1937, p. 1741.

[1560] Op. cit. supra, note 1558, Commission's Exhibit No. 1577.

[1561] Ibid.

[1562] Id., at 20229. The Delaware Trading Corporation was a personal holding company of Wallace Groves and George Groves, his brother (id., at 20229 and 20460). Wallace Groves was not directly connected with this company at the time it lent the $139,000 to Mr. Warriner (id., at 20229). However, at the time when this loan was made by Delaware Trading Corporation to Mr. Warriner, Wallace Groves was making substantial loans to Delaware Trading Corporation and to his brother, George Groves (id., at 20466). Wallace Groves

the security of the International Equities Corporation stock which he had purchased.[1563]

On February 21, 1936, Mr. Warriner contracted to purchase from Louis J. Kolb and his associates in control of International Equities Corporation, 9,211 shares of its Class A stock and 5,189 shares of its Class B stock for $266,077. Louis J. Kolb received Mr. Warriner's note for the purchase price payable six months from the date of the agreement.[1564] The shares of stock which were the subject of the agreement and which increased Mr. Warriner's control to 56% of the Class A stock and 50% of the Class B stock of International Equities Corporation, were escrowed with the National City Bank, subject to the payment of Mr. Warriner's promissory note, but he was permitted immediately to vote the stock. Mr. Warriner had himself and his associates elected to the board of directors of International Equities Corporation. Thereafter, on August 21, 1936, Mr. Warriner caused International Equities Corporation to assume his obligation of $266,077 on his promissory note due to Louis J. Kolb and to acquire the International Equities Corporation stock which Mr. Warriner had agreed to purchase. The then market value of these shares of its own stock which Mr. Warriner thus caused International Equities Corporation to acquire for $266,077, was $96,877.[1565] In the meantime, on July 28, 1936, Mr. Warriner had caused International Equities Corporation to purchase from Consolidated Funds Corporation 6,192 shares of the Class A stock and 6,310 shares of the Class B stock of International Equities Corporation for $174,960.80.[1566] The market value of these blocks of its own securities which Mr. Warriner caused International Equities Corporation to purchase was approximately $77,000.[1567] The effect of this reduction of the outstanding stock of International Equities Corporation was to increase the voting power of the shares held by Mr. Warriner to 65% of its Class A stock and 71% of its Class B stock. Thus, by the utilization of his power, as the controlling force in International Equities Corporation, to compel International Equities Corporation to repurchase its own stock, Mr. Warriner had transformed a minority voting interest in the company, which he had acquired with borrowed funds of $185,000, to an absolute majority voting interest.[1568]

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conceded that he may have had a "pecuniary interest" in the International Equities Corporation stock hypothecated with the Delaware Trading Corporation (id., at 20466). Subsequently, in January 1936, after Mr. Warriner had succeeded in acquiring control of International Equities Corporation and General Investment Corporation, Wallace Groves reacquired a stock interest in Delaware Trading Corporation from his brother, George Groves, in satisfaction of a loan (id., at 20229–30, 20462, 20466).

[1563] Id., at 20230–3.

[1564] Id., Commission's Exhibit No. 1577.

[1565] In August 1936, the bid market price of the Class A stock of International Equities Corporation, as reported by the National Quotation Bureau, was $9.25 a share. The bid market price for the Class B stock was $2.25 a share.

[1566] Op. cit. supra, note 1558, at 15128–33 and Commission's Exhibit No. 1577.

[1567] The bid market price of the Class A stock of International Equities Corporation, as reported by the National Quotation Bureau, for July 1936 was $9.75 a share. The bid market price for the Class B stock in the same month was $2.75 a share.

[1568] Mr. Warriner, in August 1936, caused International Equities Corporation to purchase control of General Investment Corporation, an investment company then possessing assets of $10,000,000, and caused General Investment Corporation in turn to purchase control of Standard Investing Corporation which possessed assets of $9,000,000. (See Ch. II of this part of the report, pp. 497–623.) Thus, without the expenditure of any of his

Similar methods were adopted by Home and Foreign Securities Corporation to acquire control of Oils & Industries, Inc., and by Chase Donaldson and his associates to acquire control of Allied General Corporation. In these cases the power of the management to alter the company's capital structure provided the means by which the purchase price of control could be provided from the assets of the acquired investment company.

b. Oils & Industries, Inc.—Home and Foreign Securities Corporation

The history of Oils & Industries, Inc., from its inception to December 1931, has already been described.[1569] As has been shown, by the purchase of a management contract, Messrs. Kahn, Watson and Herzberg had acquired control of the corporation and had misappropriated approximately $284,000 of its funds.

Upon discovery of the "fraudulent conduct" of the Watson group, the old board of directors assumed the management of the investment company until May 1932, when, again without consulting the stockholders, the board appointed Arthur S. Kleeman, the president of Home and Foreign Securities Corporation, another investment company, as president of Oils & Industries, Inc., and permitted him to appoint a majority of a new board of directors. Opposition arose to Mr. Kleeman's management and, in order to remove this opposition, Mr. Kleeman induced David Milton, president of The Equity Corporation, an investment company, to have one of his companies purchase the opposing block of stock. Thereafter, Mr. Milton's nominees constituted half of the board of the investment company.

By 1934, the David Milton interests had acquired approximately 40% of the stock of Oils & Industries, Inc. In order to prevent the contemplated absorption of Oils & Industries, Inc. by The Equity Corporation by means of an exchange offer of stock, Mr. Kleeman caused his Home and Foreign Securities Corporation to purchase the David Milton holdings at a price in excess of their asset value. In order to obtain cash to make this purchase, Home and Foreign Securities Corporation, without knowledge of its minority stockholders, liquidated virtually its entire portfolio and borrowed $360,000.

Thereafter, Mr. Kleeman utilized his control to effect a recapitalization of the investment company, which enabled Home and Foreign Securities Corporation to obtain from Oils & Industries, Inc., the necessary funds to repay the loan of $360,000. Although previously the preferred stock which was originally issued by Oils & Industries, Inc., had been eliminated to remove dividend arrearages by reclassi-

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own funds, Mr. Warriner had succeeded in acquiring control of three investment companies with aggregate assets of more than $20,000,000.

On March 9, 1937, Mr. Warriner sold his control of International Equities Corporation to investment companies controlled by Henderson Brothers of Boston (ibid., and op. cit. supra, note 1558, at 15342). From the proceeds of this sale Mr. Warriner repaid his $139,000 loan from the Delaware Trading Corporation, then controlled by Wallace Groves (id., at 20471–2), that is, the loan which had enabled him, without the investment of any of his own funds, to acquire and to dispose of control of International Equities Corporation at a profit of approximately $1,860,000. Moreover, during the period that Mr. Warriner controlled General Investment Corporation, that investment company had suffered substantial losses as the result of transactions with Wallace Groves and Phoenix Securities Corporation, an investment company controlled by Wallace Groves. (See Ch. II of this part of the report, pp. 497–623.)

[1569] See supra, pp. 1293–6.

fying such preferred stock as common stock, the new recapitalization plan authorized the issuance of new preferred stock, without voting power, to be distributed to the stockholders as a stock dividend, redeemable by the company at 95% of its asset value in 1,000 share lots only and for a period of three weeks. The stockholders approved this plan and Home and Foreign Securities Corporation redeemed all of the new preferred stock it acquired and applied the proceeds to repay the balance of the bank loan of $360,000. No other stockholder tendered, or apparently was in a position to tender, 1,000 share lots of new preferred stock for redemption. Since the new preferred stock had no voting power, Home and Foreign Securities Corporation's 40% control of Oils & Industries, Inc., was not disturbed.

Although the stockholders of Oils & Industries, Inc., had by the end of 1935 suffered realized and unrealized losses in excess of $4,000,000, the four different groups which successively controlled it were enabled to derive large profits, directly or indirectly, from their association with the investment company.[1570]

c. Allied General Corporation—Chase Donaldson, et al.

Allied General Corporation was incorporated under the laws of the State of New York on March 23, 1927,[1571] at the instance of Sterling Pile, then associated with Johnson & Higgins, insurance brokers of New York City, Edward B. Twombly, an attorney, and Goodwin Beach & Company, a firm specializing in the purchase and sale of insurance securities headed by Edward S. Goodwin, a reputed authority on insurance company securities.[1572]

Until February 1933, Allied General Corporation functioned primarily as an investment banking institution distributing and trading in the securities of investment companies organized under the auspices of its various managements.[1573] However, in February 1933, Allied General Corporation disposed of its investment banking business and became an investment company.[1574] Although Allied General Corporation may not have been an investment company at the time that its control was acquired by the Donaldson group, nevertheless the tactics adopted by that group are easily applicable to investment companies.

By December 31, 1929, Allied General Corporation (then known as Insuranshares Corporation of New York) had received from its stockholders a total of $4,456,315.60 [1575] and had issued as consideration therefor 22,285 shares of 5½% convertible preferred stock of the par and liquidating value of $100 a share and 98,928½ shares of its no par value common stock.[1576] All of the preferred stock and

[1570] See Ch. II of this part of the report for a detailed history of Oils & Industries, Inc., containing appropriate references to the record, pp. 94–114.

[1571] Public Examination, Allied General Corporation, at 4947 and Commission's Exhibit No. 455. The corporation was originally known as Insuranshares Corporation of New York. The name of Allied General Corporation was adopted February 1931 (id., at 5110).

[1572] Public Examination, Allied General Corporation, at 4947–8.

[1573] Id., at 4949, et seq. The corporation distributed the securities of Insuranshares Corporation of Delaware, Sterling Securities Corporation, and the various companies in the United Founders Corporation group of investment companies (ibid.).

[1574] Id., at 5095, 5114–6.

[1575] Id., at 5028, 5104.

[1576] Id., Commission's Exhibit No. 463.

the common stock were privately sold to dealers assisting the corporation in its investment banking operations.[1577] No public offering of the shares was ever made.

By February 1931 the net assets of Insuranshares Corporation of New York totaled approximately $1,500,000. The corporation, from 1927 to February 1931, had suffered a shrinkage in its contributed capital due to realized and unrealized losses of approximately $3,000,000.[1578]

On January 7, 1931, a contract between United Founders Corporation and Insuranshares Corporation of New York (the former name of Allied General Corporation) was executed, by the terms of which United Founders Corporation agreed to transfer to Insuranshares Coropration of New York securities having a market value equivalent to the value of the assets of Insuranshares Corporation. In consideration of the transfer of securities, United Founders Corporation was to receive approximately 50% of the securities of Insuranshares Corporation which would be issued by the corporation after a recapitalization of the corporation provided for in the agreement. Under the recapitalization plan which was approved by the company's stockholders on January 28, 1931, the existing 20,000 shares of the $100 par value preferred stock were exchanged for 20,000 shares of $3 preferred stock, of the par and liquidating value of $50 a share, and 20,000 shares of Class A stock. The outstanding 93,856 shares of common stock were exchanged for the same number of shares of new common stock accompanied by option warrants to purchase an additional 46,928 shares of new common stock on or before December 31, 1935, at $1 a share. For the investment of $1,500,000, which United Founders Corporation was to make in Allied General Corporation, it was to receive 20,000 shares of preferred, 20,000 shares of Class A, and 100,000 shares of the common stock accompanied by warrants to purchase an additional 50,000 shares of the common stock of the recapitalized corporation. Finally the name of the corporation was changed to Allied General Corporation.[1579]

Chase Donaldson, who had been president of Founders General Corporation, became the president and a director of Allied General Corporation.[1580] E. Stanley Glines, another representative of United Founders Corporation, also became a director of Allied General Corporation.[1581] Messrs. Pile, Twombly, and Goodwin of the exist-

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[1577] Id., at 4954–5.

[1578] Id., at 5103–4.

[1579] Id., at 5101–2 and Commission's Exhibits Nos. 469, 471.

[1580] Id., at 5094, 5110. Founders General Corporation was a wholly owned subsidiary of United Founders Corporation and of American Founders Corporation, primarily engaged in trading in and distributing the stock of United Founders Corporation to the public (id., at 5096). In the middle of 1930, United Founders Corporation sought to list its securities on the New York Stock Exchange. However, the New York Stock Exchange "indicated that they felt it was more desirable that a corporation not deal in its own securities through a wholly owned subsidiary [Founders General Corporation]" (id., at 5097). Thereafter the United Founders Corporation reached a decision "to set up an entirely separate agency which might still trade in the securities of the Founders group but which would have no corporate relationship with the United Founders group and which at the same time could engage in other investment banking and trading activities" (id., at 5097). As a result of this decision, United Founders Corporation agreed to purchase a 50% stock interest in Allied General Corporation in the manner which has been described.

[1581] Id., at 5113.

ing directorate continued as directors of Allied General Corporation.[1582]

By December 31, 1931, the value of the assets of Allied General Corporation had declined to approximately $1,200,000, as compared with the approximately $3,000,000 in assets held by the corporation immediately after its recapitalization in February 1931.[1583] The assets of the corporation on January 20, 1932, if it were then dissolved, would have been sufficient to pay only $37.79 on each of the outstanding 36,900 shares of the corporation's preferred stock which, under the company's charter, had a preference in assets on the company's dissolution of $50 a share. As a consequence, the outstanding Class A and common stock of the corporation were without asset value. United Founders Corporation and its subsidiaries held, in January 1932, 19,630 shares of the preferred stock, 19,630 shares of the Class A stock, and 100,000 shares of the common stock of Allied General Corporation. These holdings constituted 52% of the outstanding securities of the corporation.[1584] The total asset value of the United Founders Corporation group's holding of Allied General Corporation securities was approximately $740,000,[1585] as compared with the original investment of approximately $1,500,000 in these securities. In other words, United Founders Corporation had sustained a loss of approximately 50% of its investment in Allied General Corporation. Mr. Donaldson testified that United Founders Corporation at this point was "willing or would be sympathetic to selling out the Allied General business."[1586]

Meanwhile, in the fall of 1931, Chase Donaldson and a group of his associates[1587] in the management of Allied General Corporation determined to acquire control of Allied General Corporation by purchasing the holdings of United Founders Corporation. Prior to January 1932, this group had purchased a total of 34,163 shares of the common stock of Allied General Corporation. These shares, however, had been pledged by the group with Manufacturers Trust Company to secure a loan of $20,000 made by the bank to the group to finance the purchase of the shares.[1588] The Donaldson group, after some negotiation with United Founders Corporation, obtained its agreement to dispose of its holdings in Allied General Corporation for a total price of $540,000, being $27.50 a share for the 19,630 shares of preferred stock held by United Founders Corporation.[1589] The Class A and common stock interest in Allied General Corporation held by Founders were to be transferred to the syndicate free of charge. As has been indicated, these securities had no asset value. Although the price to be paid by the Donaldson group for the holdings of the United Founders Corporation group in Allied General Corporation was approximately $10 less than the liquidating value of each share

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[1582] Id., Commission's Exhibit No. 475.

[1583] Id., at 5164.

[1584] Id., Commission's Exhibit No. 494.

[1585] The 19,630 shares of the preferred stock of Allied General Corporation had an asset value of $37.79 a share or a total asset value of approximately $740,000.

[1586] Op. cit., supra, note 1572, at 5188.

[1587] Id., Commission's Exhibit No. 496. Mr. Donaldson's associates were: Dean J. Almy, Herbert R. Anderson, W. F. Best, R. S. Elliott, Jr., Alfred M. Elsesser, Kenneth S. Gaston, and Eliot Sharp (ibid.).

[1588] Id., at 5191–2.

[1589] Id., Commission's Exhibit No. 494.

of Allied General Corporation preferred stock to be sold by United Founders Corporation, the purchase price was greatly in excess of the then market value of the preferred stock which was then selling in a very inactive market on the New York Produce Exchange at $8 a share.[1590] The contemplated purchase price to be paid by the Donaldson group was approximately $382,785 above the quoted market value of the Allied General Corporation preferred shares to be acquired from the United Founders Corporation group.

However, Mr. Donaldson and his associates were without funds to effect the purchase of United Founders Corporation's interest in Allied General Corporation.[1591] Apparently a bank loan could not be obtained without the guaranty of a financially responsible individual.

In December 1932, Mr. Donaldson, largely through his half-brother, John W. Donaldson,[1592] then a vice president of Atlas Corporation, enlisted the aid of Atlas Corporation in his plans to acquire control of Allied General Corporation. Atlas Corporation in 1931 had acquired control of 12 investment companies [1593] and in 1932 was primarily engaged in acquiring additional shares of its controlled companies at their market prices which were substantially less than the asset values of such shares.[1594] Allied General Corporation's nation-wide security dealer contacts and its extensive securities distribution organization would obviously be of material assistance to Atlas Corporation in accomplishing its objective. In January 1932, Chase Donaldson and Atlas Corporation reached an oral agreement that Allied General Corporation after its acquisition by Mr. Donaldson would aid Atlas Corporation in its investment company acquisition program. Under the plan, Allied General Corporation was to purchase Atlas Corporation's securities in the open market and exchange them for securities of Atlas Corporation's controlled companies on a market value basis. The securities of the companies controlled by Atlas Corporation, so acquired by Allied General Corporation,[1595] were to be purchased by Atlas Corporation. Allied General Corporation was to receive a commission from Atlas Corporation for its services.[1596]

Atlas Corporation further agreed to guarantee [1597] a loan to be made by Manufacturers Trust Company to Chase Donaldson and his associates in the sum of $560,000, of which $540,000 was to be used to purchase the United Founders Corporation's controlling interest in Allied General Corporation and $20,000 was to constitute a renewal of the $20,000 loan already made by the bank to the Donaldson group. The shares of Allied General Corporation acquired from United Founders Corporation were to be pledged with the bank to secure the

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[1590] During March 1932, according to the *Bank and Quotation Record*, only 200 shares of the preferred stock of Allied General Corporation were traded on the New York Produce Exchange. The market price was $8 a share. No trading in the stock occurred in December 1931, or in January and February 1932.

[1591] Op. cit. supra, note 1572, at 5197

[1592] Id., at 5196, 5201.

[1593] See supra, p. 1057.

[1594] Ibid.

[1595] Op. cit. supra, note 1572, at 5223, 5245–6.

[1596] Id., Commission's Exhibit No. 495; Public Examination, Atlas Corporation, Commission's Exhibit No. 2002 (p. 57).

[1597] Op. cit. supra, note 1572, Commission's Exhibit No. 497.

loan.[1598] In consideration of its guaranty, Atlas Corporation was to receive from the Donaldson group on repayment of the loan 9,815 shares of the Class A stock and 37,500 shares of the common stock of Allied General Corporation.[1599] These shares, however, were never received by Atlas Corporation. Eventually it was paid by the Donaldson group for its guaranty in another manner.[1600]

However, the problem of the repayment of the loan remained. To meet this problem, Chase Donaldson presented to Atlas Corporation a plan [1601] whereby the control to be possessed by Mr. Donaldson over the corporate assets of Allied General Corporation would be utilized to repay the loan. Briefly, the Donaldson plan was to reduce, with the stockholders' approval, the capital allocated to the preferred stock of Allied General Corporation in order to create a paid-in surplus. With this surplus, Donaldson intended to retire preferred stock of the corporation in the ratio of one share to be purchased from himself and his associates for each share purchased from the public. The Donaldson group, however, was to receive a more favorable price for their shares.[1602] Further, Donaldson intended to use the prospective profits, to be derived by Allied General Corporation as commissions made in effectuating exchanges of Atlas Corporation's securities for the securities of its controlled companies, to purchase preferred stock and to pay dividends on the preferred and other securities of Allied General Corporation. From these dividends and purchases of their preferred shares, funds would be derived by the Donaldson group with which to pay off the loan. The purchase price to be paid Allied General Corporation for its preferred stock securing the loan made by Manufacturers Trust Company was to be applied by the bank in reduction of the loan.

This projected method of repayment of the loan was described to Atlas Corporation in a memorandum [1603] dated January 22, 1932, written by Chase Donaldson. This memorandum states in part:

As soon as control is acquired, a special stockholders meeting would be called (February or March) to—

a. Restate value of stock from $50 to $5, creating capital surplus.

b. Authorize immediate purchase and retirement of 10,000 shares of Preferred Stock out of capital surplus so created.

c. Authorize purchase and retirement of such additional amounts as Executive Committee shall determine, but only out of realized net profits after Preferred dividend requirements in any one month.

NOTE TO MR. GIBSON [president of Manufacturers Trust Company]: These plans not to be known to Founders.

About February to March: Allied General Preferred, Class A and Common stocks might be listed on the Curb, and the Company would purchase 10,000 shares of Preferred, of which 5,000 shares from Public and 5,000 shares from Syndicate: Average price less than $20 a share. Syndicate would pay off the loan by $125,000 from proceeds (5,000 shares × $25), leaving a loan of $435,000 * * *.

[1598] Id., Commission's Exhibits Nos. 495, 497.

[1599] Id., Commission's Exhibit No. 497.

[1600] See infra, p. 1357.

[1601] Op. cit. supra, note 1572, Commission's Exhibit No. 494.

[1602] See infra, pp. 1354–5.

[1603] Op. cit. supra, note 1572, Commission's Exhibit No. 494.

March to June: Depending upon earnings, it would be the plan of the Syndicate to apply all net profits each month to the retirement of Preferred Stock. With present and projected business (particularly Atlas exchange) it might be possible to purchase and retire another 5,000 shares at $25 ($125,000) largely from the Syndicate account, leaving loan—$310,000.

It will be noted that while the 10,000 shares of preferred stock which were to be purchased from the surplus created by the reduction of the capital allocable to the preferred stock, were to be acquired at an average of less than $20 a share, 5,000 of the shares to be retired were to be acquired from Donaldson and his associates at $25 a share. In other words, those in control, it was contemplated, would receive a higher price for their shares than would be paid for the shares held by the public. Further, the retirement of the corporation's preferred stock by purchases below the asset value of such stock would enhance the asset value of the Class A and common stocks held by the Donaldson group. The group would hold the majority of these securities which also constituted control of the company.[1604]

Atlas Corporation apparently agreed to the proposed method by which the loan was to be repaid.[1605] On January 29, 1932, the transaction between United Founders Corporation and the Donaldson group was closed. A loan in the sum of $560,000 by the group was procured from the Manufacturers Trust Company.[1606] In accordance with its agreement, this loan was guaranteed by Atlas Corporation.[1607]

The connection of Atlas Corporation with the transaction and the proposed method by which the Donaldson group intended to repay the loan were intentionally concealed from United Founders Corporation. Mr. Donaldson testified that these facts were concealed from United Founders Corporation because of the fact that if United Founders Corporation had been aware of Atlas Corporation's connection with the transaction, "they might have tried to raise the price on us."

Mr. Donaldson testified further:[1608]

Q. You said you felt if they [United Founders Corporation] knew the method by which you hoped to purchase the stock that they might increase the price?

A. Perhaps, I didn't make myself clear. This is what was in my mind at the time. I felt that if the people in United Founders believed that we had a highly profitable sort of business accruing to us, one or two things might have happened; either they wouldn't have sold to us or they would not have looked with any great favor on our doing business with the Atlas Corporation. To put it briefly, I was between two fears as to what course to take. It seemed logical not to disclose to the Founders group that the Atlas Corporation was guaranteeing the loan, for those two reasons I have stated to you.

Q. After all, you were an officer of Allied General at that time.

A. Yes, sir.

[1604] Id., at 5207–8.

[1605] Id., at 5200. Mr. Donaldson testified (ibid.):

> I disclosed to the Atlas Corporation all of the contemplated methods which might be used to retire this loan, including possible profits from our relationship with them, including retirement of stock by purchase, and I can only repeat this memorandum which you state was handed to the other corporation.

[1606] Id., Commission's Exhibit No. 499.

[1607] Id., Commission's Exhibit No. 498.

[1608] Id., at 5205–7.

Q. And Founders were stockholders in that corporation, weren't they?

A. Yes.

Q. As stockholders, didn't you think you owed them any duty as to complete disclosure in connection with any transaction you were consummating?

A. I didn't think so in this case.

Promptly on their accession to control of Allied General Corporation in February 1932, the Donaldson group proceeded to carry forward their projected plan for repayment of the borrowed funds which they had used to acquire control of Allied General Corporation. On February 19, 1932, stockholders were informed by letter [1609] of a meeting to be held on March 8, 1932, to consider a reduction of the capital of the corporation allocable to its preferred stock from $50 to $10 a share.[1610] The net capital surplus (after creating a reserve for depreciation in value of portfolio securities) thus to be created amounted to approximately $641,000.[1611] The letter stated that this surplus would be available for retirement of the corporation's preferred shares. Not revealed in the letter, however, was the method by which Mr. Donaldson and his associates had acquired control of the corporation nor the fact that the preferred shares pledged by the group to secure their loan were to be repurchased. In fact, a direct inquiry in a letter [1612] dated February 25, 1932, from one Harry Buford, a preferred stockholder, as to whose shares were to be repurchased, was answered without revealing the fact that the controlling group intended to use the surplus to be created to purchase their own shares as well as the shares held by the public.[1613]

On March 8, 1932, the proposed reduction of the capital of the corporation allocable to the preferred stock was approved by more than two-thirds of the shares.[1614] The Donaldson group which held in excess of 50% of the shares of each class of the corporation's securities voted their stock in favor of the plan.

In May and July 1932, Allied General Corporation purchased from the Donaldson group 3,500 shares of its preferred stock at a price of $15 a share.[1615] The market price of these shares on the dates they were purchased was approximately $8 a share.[1616] The $52,500 thus raised by the group was used to reduce the loan at Manufacturers Trust Company.[1617] The discriminatory nature of these purchases by the corporation from the Donaldson group is indicated by the fact

[1609] Id., Commission's Exhibit No. 500.

[1610] Ibid.

[1611] Id., at 5229.

[1612] Id., Commission's Exhibit No. 504–A. Mr. Buford's letter stated: "Whose stock and at what prices would be purchased is not intimated. Naturally."

With reference to the letter, Mr. Donaldson testified (id., at 5243):

Q. Of course, he [Mr. Buford] evidently didn't know that it was anticipated that at least a portion of the stock owned by the controlling interest of Allied General was to be purchased; isn't that so?

A. You say of course he didn't know?

Q. I mean of course the letter indicates that he didn't know, because he specifically asked that question.

A. He was advised stock was going to be purchased by the corporation, but he was not advised that any of the stock was going to be purchased from any given individual.

[1613] Id., Commission's Exhibit No. 504–B.

[1614] Id., Commission's Exhibits Nos. 504–E, 509–F, 509–K.

[1615] Id., Commission's Exhibits Nos. 509–F, 509–K.

[1616] Id., Commission's Exhibits Nos. 509–G, 509–J.

[1617] Id., Commission's Exhibit No. 499.

that from February 1932 to December of the same year, Allied General Corporation acquired from the public a total of 6,921 shares of its preferred stock at an average price of $12.05 a share.[1618]

Ultimately, however, the plan for repayment of the loan by the Donaldson group became impossible of fulfillment for two reasons. First, under the management of Mr. Donaldson and his associates, Allied General Corporation engaged in extensive short selling of its portfolio securities.[1619] By July 1932, these short sales had resulted in a loss to the corporation of over $500,000,[1620] a loss sufficient to erase most of the capital surplus which had been created by the reduction of the capital allocable to the preferred stock in March 1932. Secondly, in June 1932, Atlas Corporation itself determined to make exchange offers of its securities for the securities of its controlled companies.[1621] As a consequence, the expected profits to be earned by Allied General Corporation in effectuating Atlas Corporation exchanges did not materialize. On December 13, 1932, Atlas Corporation paid $50,000 to Allied General Corporation in full settlement of its services in aid of the Atlas Corporation exchange program.[1622]

On December 7, 1932, Mr. Donaldson and his associates, as has already been described, in conjunction with Wallace Groves, caused the incorporation of The Equity Corporation in Delaware.[1623] The Allied General Corporation shares owned by the Donaldson group were transferred to The Equity Corporation in consideration of the receipt by the Donaldson group of 500,000 shares of common stock of The Equity Corporation.[1624] These Equity Corporation shares on December 13, 1932, were substituted with Manufacturers Trust Company as collateral for its loan which then stood at $490,000.[1625] The bank simultaneously released the Allied General Corporation shares to The Equity Corporation. Of the total of $70,000 by which the loan had been reduced by the Donaldson group, $52,500, as has been indicated, had been realized by the purchase by Allied General Corporation of 3,500 shares of its preferred stock from the group; the remainder had been paid from the personal funds of the group.[1626]

Eventually, the loan was repaid by sales of The Equity Corporation stock held by the bank as collateral. Included in the purchasers of The Equity Corporation stock were Allied General Corporation itself which on December 13, 1932, purchased 40,500 shares of the stock at a total cost of $40,500.[1627] By June 28, 1933, the loan had been liquidated. Atlas Corporation was thereupon released from its

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[1618] Derived from supplementary information supplied the Commission for Allied General Corporation. At or about the time that the Donaldson group was purchasing its own holdings of the preferred stock of Allied General Corporation at a price of $15 a share, Allied General Corporation offered to exchange some of its portfolio securities having a market value of $11 for each share of its preferred stock (op. cit. supra, note 1571, Commission's Exhibit No. 509–J).

[1619] Id., at 5249–51 and Commission's Exhibit No. 505.

[1620] Id., at 5250–1.

[1621] Id., at 5247 and 5259–60.

[1622] Public Examination, Atlas Corporation, Commission's Exhibit No. 2002 (p. 57).

[1623] See supra, pp. 1039–41.

[1624] Op. cit. supra, note 1571, at 5294.

[1625] Id., at 5295.

[1626] Id., at 5240.

[1627] Id., at 5295.

guaranty. Atlas Corporation was compensated for its guaranty in the following manner: On June 28, 1933, Atlas Corporation caused several of its subsidiaries to purchase 50,000 shares of common stock of The Equity Corporation held by Manufacturers Trust Company as collateral on its loan to the Donaldson group, for $50,000.[1628] This $50,000 was applied by the bank in reduction of its loan to the Donaldson group. On June 18, 1933, Allied Distributors, Inc., a company controlled by Chase Donaldson, purchased from the Atlas Corporation subsidiaries these 50,000 shares of stock of The Equity Corporation for $62,500.[1629] Atlas Corporation, through its subsidiaries, thus derived a profit of $12,500.[1630]

IV. EXCHANGE OFFERS

A. Function of Exchange Offers in Programs of Acquisition of Investment Companies

In connection with the acquisition of control of investment companies, various devices were employed to obtain the active cooperation or at least the acquiescence of the existing managers or sponsors of the acquired companies to the plans of the acquiring corporation or individual. The objectives of acquiring corporations or indivduals may have ranged from direct conversion of the assets of the acquired company to their own use, or to the acquisition in connection with expansion programs of all the outstanding shares of the acquired companies for a total consideration less than their actual asset value. In the course of these expansion programs extensive use was made of exchange offers with the ultimate aim of absorbing, by the legal techniques of dissolution, merger, and consolidation, the assets of the companies acquired.[1] In this manner there would be realized the gains desired as a result of the spread between the asset value of the shares of acquired companies, and their cost in cash or in securities to the acquiring company.[2] To accomplish this purpose, therefore, it was necessary to acquire the percentage of voting stock necessary, under applicable State laws, to effect the dissolution, merger, or consolidation of the acquired company.[3]

[1628] Derived from supplementary information supplied the Commission for Atlas Corporation.

[1629] Ibid.

[1630] Ibid., and op. cit. supra, note 1572, at 5252.

[1] Atlas Corporation and The Equity Corporation engaged in the largest of these expansion programs. The activities of Atlas Corporation will be discussed in detail in this section. The activities and methods of solicitation adopted by The Equity Corporation in its exchange offer program have been described in detail in the Commission's Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1938), Part VII, Sec. IV.

[2] Public Examination, Atlas Corporation, at 17722–3.

[3] By the laws of Delaware (Del. Rev. Code (1935) c. 65 § 39), the situs of incorporation of most of the corporations acquired by Atlas Corporation and The Equity Corporation, a voluntary non-judicial dissolution of a corporation can be effected only with the consent of the holders of two-thirds of the voting shares of the corporation. Similarly, a merger or consolidation of a Delaware corporation (Del. Rev. Code (1935) c. 65 § 59) can be effected only with the consent of the holders of two-thirds of the corporation's capital stock. Under the laws of Maryland, a state in which several of the corporations absorbed by Atlas Corporation and The Equity Corporation were incorporated, the consent of the holders of two-thirds of each class of voting stock, voting by classes, is a prerequisite to a voluntary dissolution, merger, or consolidation of their company (Md. Code Ann. [Flack Supp. 1935] Art. 23 §§ 33, 33½, 34, 35, 91).

The exchange offers primarily served to increase the holdings of the acquiring company in the stocks of its controlled companies to the point where, by its voting power, it could effect a merger, dissolution, or consolidation of the controlled companies. In some cases, although infrequently, the exchange offer was used initially to acquire control itself.[4]

However, the usual procedure of the acquiring corporation was to acquire working control (by a transaction with the former sponsors or managers of an investment company) and, thereafter, to augment its holdings by exchange offers. In many cases open-market purchases were made of the securities of acquired companies. Usually, however, market purchases failed to increase the holdings of the acquiring corporation to the statutory quantum of voting stock necessary to dissolve, merge, or consolidate the controlled company. A substantial number of minority stockholders usually desired to retain a continuing interest in the assets of their company.[5]

Mr. Odlum testified[6] that one of the primary purposes of the exchange offers was to enable Atlas Corporation to "clear away" its acquired companies, that is, to acquire a sufficient amount of their voting shares to effect their dissolution, merger, or consolidation:

> Q. And then in all instances * * * an exchange offer was made of Atlas Corporation stock for the stock of these various companies, isn't that so?
>
> A. I would be inclined to say yes, because that was the only way that they could be cleared away.

To accomplish the purpose of eliminating this minority interest, a large number of various exchange offers were made,[7] and almost invariably the quantum of voting stock necessary to absorb the assets of the acquired company by the process of liquidation, merger, or con-

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[4] Thus, of the 22 investment companies which were assimilated by Atlas Corporation, control of only 7—All America General Corporation, Allied Atlas Corporation, Power and Light Securities Trust, Selected Stocks, Inc., Iroquois Share Corporation, Jackson & Curtis Investment Associates, and Atlantic Securities Corporation—were acquired by means of exchange offers. In each of these cases, however, acceptance of the exchange offers was recommended by the sponsors, managers, and directors of the acquired corporation. In 6 of these cases the exchange offers resulted in the acquisition by Atlas Corporation of a sufficient amount of voting stock to effect the dissolution, merger, or consolidation of the acquired companies (op. cit. supra, note 2, Commission's Exhibits Nos. 1962, 1963, 1970, 2001).

[5] As Mr. Odlum testified (id., at 17726):

> Q. I don't dispute that initially you got into the trust by purchasing for cash from the sponsor but getting the securities in was effected by the medium of exchanges.
> A. That was a necessary incident of the others. The objective was to get as many in as we could for cash, and we had to use exchanges because many people didn't want to sell their trust stocks for cash, they felt that they had taken the loss and they wanted to ride back with the thing and therefore to complete the program after we bought all that we could for cash, we had to give them a position in our company to allow them to come back with the portfolio.

[6] Id., at 17729.

[7] Atlas Corporation made 43 exchange offers for the securities of 21 investment companies. Similarly, The Equity Corporation made almost 50 exchange offers for securities of 14 investment companies (id., Commission's Exhibits Nos. 1970 and 2001, and Public Examination, The Equity Corporation, Commission's Exhibits Nos. 839 and 840). The total includes the offers made to the stockholders of Colonial States Fire Insurance Company and Majestic Fire Insurance Company of New York after they had been merged, by successive steps, into America Colony Insurance Company. The exchange offer made to the stockholders of Germanic Fire Insurance Company of New York, which had been merged with American Colony Insurance Company in 1931 before The Equity Corporation had been organized has not been included (ibid.).

solidation had been acquired.[8] Table 18 [9] indicates the percentage of the outstanding stock of its controlled companies ultimately acquired by the Atlas Corporation, and indicates the percentage of such stock which was acquired by purchase and by exchange offer. It will be noted that of the total securities acquired by Atlas Corporation in 14 of the controlled companies, 30%, or more, of such securities were acquired through the medium of exchange offers.

TABLE 18.—*Shares of investment trusts acquired by Atlas Corporation by purchase and exchange, as of Dec. 31, 1935*

Name of corporation	Type of security	Total shares acquired	Percent of outstanding	Total shares purchased	Percent of purchases to shares acquired	Total shares exchanged	Percent of exchanges to shares acquired
All America General Corporation.	Common	164,213	99.0	53,696	32.7	110,517	67.3
	Warrants	65,239	97.0	23,451	35.9	41,788	64.1
Allied Atlas Corporation	Common	279,576	97.0	36,484	13.0	243,092	87.0
Power and Light Securities Trust.	Certificates of beneficial interest.	60,721	95.0	4,942	8.1	55,779	91.9
	Warrants	75,237	94.0	33,703	44.8	41,534	55.2
Selected Stocks, Inc	Common	14,710	99.9	2,480	16.9	12,230	83.1
	Warrants	21,386	99.0	1,445	6.8	19,941	93.2
Ungerleider Financial Corporation.	Common	215,025	97.0	187,386	87.1	27,639	12.9
Iroquois Share Corporation	do	154,327	97.0	14,025	9.1	140,302	90.9
	Warrants	71,500	100.0			71,500	100.0
Federated Capital Corporation	Preferred	116,453	94.0	77,957	67.5	37,496	32.5
	Common	172,985	69.0	68,583	39.7	104,402	60.3
General Empire Corporation	do	200,047	99.0	47,783	23.9	152,264	76.1
	Warrants	106,426	100.0	106,426	100.0		
Jackson & Curtis Investment Associates.	Certificates of beneficial interest.	21,146	95.0			21,146	100.0
Securities Allied Corporation	Common voting.	100,000	100.0	100,000	100.0		
	Common nonvoting.	1,334,057	96.0	654,109	49.0	679,948	51.0
Chain Store Stocks, Inc	Common	220,205	95.0	158,723	72.0	61,482	28.0
	Warrants	100,000	100.0	100,000	100.0		
National Securities Investment Co.	Preferred	133,308	97.0	89,221	67.0	44,087	33.0
	Common	855,985	92.0	705,433	82.0	150,552	18.0
Aviation Securities Corporation	do	131,130	97.9	109,817	83.7	21,313	16.3
	Warrants	43,834	43.0	43,834	100.0		
Sterling Securities Corporation	First preferred	176,751	75.0	141,029	79.8	35,722	20.2
	$1.20 preference	308,624	61.0	231,457	75.0	77,167	25.0
	Common A	275,859	45.0	210,393	76.3	65,466	23.7
	Common B	263,688	88.4	251,058	95.2	12,630	4.8
Atlantic Securities Corporation	Preferred	49,983	98.0	492	1.0	49,491	99.0
	Common	164,609	98.0	1,336	.8	163,273	99.2
	Warrants	18,693	100.0	18,693	100.0		

[8] Public Examination, The Equity Corporation, Commission's Exhibits Nos. 128, 784–A, 829, 839, 840, 843, 844, 1183; op. cit. supra, note 2, Commission's Exhibits Nos. 1962, 1963, 2001.

[9] Op. cit. supra, note 2, Commission's Exhibits Nos. 1962, 1963, 2001. A similar table for The Equity Corporation is contained in the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), Part VII, p. 293.

TABLE 18.—*Shares of investment trusts acquired by Atlas Corporation by purchase and exchange, as of Dec. 31, 1935*—Continued

Name of corporation	Type of security	Total shares acquired	Percent of outstanding	Total shares purchased	Percent of purchases to shares acquired	Total shares exchanged	Percent of exchanges to shares acquired
American Investors, Inc.	Preferred	19,697		5,527	28.1	14,170	71.9
	Common	788,406	83.0	444,250	56.4	344,156	43.6
	Warrants	334,721	75.0	41,720	12.5	293,001	87.5
Goldman Sachs Trading Corporation, The.	Common	4,014,332	73.7	2,394,137	59.6	1,620,195	40.4
Shenandoah Corporation	Preference	201,734	46.8	152,722	75.7	49,012	24.3
Held by The Goldman Sachs Trading Corp.,	do	166,980	38.7				
	Common	3,025,717	51.3	2,942,306	97.2	83,411	2.8
Do	do	2,653,068	44.7				
Blue Ridge Corporation	Preference	162,237		115,322	71.1	46,915	28.9
	Common	405,672	11.1	163,861	40.4	241,811	59.6
Held by Shenandoah Corp.	do	6,330,385	84.5				
American, British & Continental Corporation.	Debentures	2,068,500		2,068,500	100.0		
	Preferred	59,417		51,704	87.0	7,713	13.0
	Common	461,562		440,954	95.5	20,608	4.5
Reliance International Corporation.	Preferred	38,288		38,288	100.0		
	Class A	300,192		192,946	64.3	107,246	35.7
	Class B	3,700				3,700	100.

B. Effects and Terms of Exchange Offers

The exchange offer served as a mechanism for acquiring the securities of minority stockholders who desired a continuing interest in the assets of their companies. Essentially the offers constituted a step in the reorganization of the rights of minority stockholders. By acceptance of the offers they retained an interest in the assets of their company, but only indirectly as stockholders of the investment company which eventually was to absorb the assets of their companies. The exchange offers, in effect, contained the terms of the readjustment of the rights of minority stockholders who accepted the exchange offers.

Similarly, the rights of minority stockholders who refused to accept the exchange offer were substantially affected. As this Commission has stated in another of its reports [10] with reference to the exchange offers of The Equity Corporation:

> Those who did not accept the exchange offer did not retain the status they held before the offer was made. After the conclusion of the exchange program they might be made stockholders of Equity by operation of law, i. e., by a merger or consolidation, unless they exercised their statutory right of appraisal. The corporation in which they held stock might be dissolved by Equity, and in that case they would receive a pro rata share of its assets. In no event would they be permitted to remain as stockholders of the old company. These changes in their status would be forced upon them. The exchange program must be considered against this background. It cannot be regarded as a series of offers

[10] Commission's Report on The Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), Part VII, p. 230.

to individual stockholders whose decision to accept or reject the offers effected only themselves. It must, as we have stated, be regarded as an integral part of Equity's reorganization procedures.

The ultimate effect of the exchange offers and the subsequent merger, consolidation, or dissolution was essentially the same as the effect of a solicitation of deposits or assets in support of a reorganization plan which is consummated in judicial proceedings. If the exchange offer were followed by liquidation and dissolution, minority stockholders, as we shall see, would be forced to take a distributive share, as in the case of reorganizations consummated through equity receivership and foreclosure. If the offers were followed by a merger or consolidation, minority holders would be bound to this program by operation of law, similar to the manner in which minorities are bound by the vote of the majority in proceedings under Section 77B of the Bankruptcy Act * * *.

As has been previously pointed out, the entire process of the transfer of control and ultimate amalgamation of investment companies was accomplished without the supervision of any independent, private or public agency. This lack of supervision was particularly true of the exchange offers.[11]

[11] Under the Securities Act of 1933, in the absence of an exemption from registration, all relevant facts with reference to the terms of exchange offers of the securities of one company for those of another made by the use of the mails or the facilities of interstate or foreign commerce must be disclosed in a registration statement filed with the Commission and in the solicitation literature or prospectus exhibited to prospective exchanging stockholders. The Commission, however, has no power to pass on the fairness or adequacy of the terms of the exchange offers.

The Equity Corporation registered its exchange offers made in 1933 and 1934 under the Securities Act of 1933, Securities Registration Statement, Form A–1, The Equity Corporation, File No. 2–684. Atlas Corporation, on the other hand, ceased making public exchange offers almost immediately upon the passage of the Securities Act of 1933. In fact, the passage of the Securities Act of 1933 was apparently the motivating factor in the termination by Atlas Corporation after July 25, 1933, of general exchange offers for the securities of the controlled companies (op. cit., supra, note 2, Commission's Exhibit No. 1984).

Those state securities acts (commonly known as Blue Sky Laws) which require registration of securities prior to their sale within the state also include within their scope exchange offers of securities. (See Parker, Corporation Manual (1937), Part III, passim.) The great majority of the state statutes, however, do not specifically empower the administrator of their securities laws to pass on the fairness of exchange offers. A notable exception is the California statute (California Corporate Securities Act, L. 1917, C. 532, as amended, § 4), which empowers the state commissioner of corporations "to approve the terms and conditions [of exchange offers] after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchanges shall have a right to appear."

However, the securities acts of the various states apply only if the exchange technically and legally occurs within the state. By arranging for the exchange to take place technically in a state (such as New York or New Jersey) which has no statutory requirements that securities be registered with a state official prior to their issuance within the state, the laws of other states requiring registration of securities to be exchanged, or, in the case of California, empowering an administrative agency to pass on the fairness of such exchanges, can be avoided. Significantly, all of the Atlas Corporation exchange offers were arranged to occur technically in Jersey City, New Jersey, by the deposit of the stock to be exchanged with a Jersey City bank (op. cit. supra, note 2, Commission's Exhibit No. 1970). For example, on June 14, 1932, Atlas Corporation offered to exchange its securities for the shares of The Goldman Sachs Trading Corporation and authorized California holders of the latter corporation's stock to deposit such stock with the Wells Fargo Bank and Union Trust Company in San Francisco. Apparently Atlas Corporation thereafter discovered that this procedure might bring it within the scope of the California Securities Act, for on June 25, 1932, it advised The Goldman Sachs Trading Corporation's stockholders that all stock certificates of that corporation to be exchanged were to be forwarded to The Commercial Trust Company in Jersey City, N. J. On July 22, 1932, Atlas Corpor-

The terms of the exchange offers were formulated only by the officers and directors of the acquiring corporation, although in some cases the prior sponsors and statistical agencies were also consulted. Usually the same individuals were also the officers and directors of the controlled companies to whose stockholders the offers were to be made. There was absent, therefore, the presumably arm's-length negotiations with reference to a merger or consolidation which exists where the merging corporations have independent boards of directors each attempting to receive the best terms for their own stockholders. Further, the managements of the acquiring corporations were primarily interested in promulgating exchange offers which were most favorable to their corporations in which they may have had substantial interests.[12] The larger the asset gains to the acquiring corporation as a result of the exchange offers, the larger would be the asset gains to the management.

In fact, the exchange offers were almost invariably fixed in ratios which resulted in substantial asset losses to the accepting minority shareholders of the controlled investment companies.[13] In nearly every case the asset value of the stock of companies acquired by exchange offers was substantially higher than the asset or even the

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ration advised those California holders of The Goldman Sachs Trading Corporation's stock who had deposited their shares with the Commercial Trust Company that "it had been suggested" that the exchange might be subject to provisions of the California securities act with which Atlas Corporation "for the present" did not desire to comply and offered to permit such stockholders of The Goldman Sachs Trading Corporation to rescind the exchanges (ibid.).

The Goldman Sachs Trading Corporation itself in August 1929, when it made an exchange offer of its securities for the securities of American Company, a California Corporation with a large number of California stockholders, took steps to arrange for the technical occurrence of the exchange in Jersey City, N. J. (Public Examination, The Goldman Sachs Trading Corporation, at 17008, et seq., and Commission's Exhibit No. 1781). In 1932 numerous American Company stockholders brought suit against The Goldman Sachs Trading Corporation to recover the market value of their American Company shares at the date of the exchange on the ground that The Goldman Sachs Trading Corporation had failed to comply with the California Securities Act. A judgment against The Goldman Sachs Trading Corporation would have compelled it to pay approximately $80,000,000 to American Company stockholders. However, the California Supreme Court in 1937 held that the California Securities Act had not been applicable to the exchanges which had intentionally been arranged to occur and had in fact occurred outside of the State of California. (*Robbins* v. *Pacific Eastern Corporation*, 8 Cal. (2d) 241; 65 P (2d) 42 (1937); Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1784.)

[12] For example, David Milton and his associates held 50.1% of the common stock of The Equity Corporation. Mr. Milton and his associates had 1,000,000 shares of the common stock of The Equity Corporation (Public Examination, The Equity Corporation, Commission's Exhibits Nos. 831 and 837). As at May 31, 1933, immediately prior to the institution of The Equity Corporation's exchange program, The Equity Corporation had outstanding 1,995,957.67 shares of common stock and 15,106⅝ shares of preferred stock, all of which had voting power (id., Commission's Exhibit No. 1177).

Similarly, Mr. Odlum and the other directors and officers of Atlas Corporation held approximately 20% of the common stock of Atlas Corporation immediately prior to the promulgation of its June 4, 1932, offers to the stockholders of 12 of its controlled investment companies (op. cit. supra, note 2, Commission's Exhibit No. 1970). Asset gains made by Atlas Corporation would redound to the pro rata benefit of Mr. Odlum and his associates. The enhancement in value of the common stock of Atlas Corporation as the result of its expansion program has already been indicated. See supra, pp. 1069–70.

[13] See the cases supra, Sec. III. As has been shown, the gross asset loss (before taking into account the partial return of assets accruing to accepting stockholders by virtue of their becoming Atlas Corporation stockholders) suffered by shareholders of Atlas Corporation's controlled investment companies who accepted its offers was approximately $13,000,000.

market value of the securities offered in exchange. The market value of the acquiring corporation's securities offered, however, always slightly exceeded the market value of the securities of acquired companies which were exchanged.[14]

Thus, acceptance of the offers of the acquiring corporation involved an immediate asset loss to the accepting stockholders of the controlled investment companies although they obtained a slight gain in market value.[15]

C. Solicitation Methods

1. ELIMINATION OF SOURCES OF INDEPENDENT ADVICE

Affirmative action on the part of minority stockholders to obtain more favorable terms of exchange was difficult, if not impossible. Normally, these stockholders could not unite in committees or otherwise to press collectively a demand for more favorable terms. Lists of stockholders were usually available only to acquiring corporations. Minority stockholders could only obtain such lists by consent of the acquiring corporation or by legal proceedings.[16] If such lists were obtained, the expense of circularization of other stockholders would probably be beyond the means of the ordinary stockholder. And as a result of the methods employed by the acquiring corporations to obtain control, those who had occupied a position of trust to stockholders of the controlled companies had usually severed their connection with the company on advantageous terms. These individuals, whether sponsors, directors or original distributors of the acquired company's securities, would therefore have little incentive to lead any opposing movement against the terms of the offers of exchange of the acquiring

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[14] Op. cit. supra, note 2, Commission's Exhibits Nos. 1962, 2001. Mr. Odlum testified (id., at 17773–4):

> Q. But the Atlas Corporation hoped to make its money * * * through the technique of getting assets and giving in return market value, isn't that so?
> A. We were getting something—essentially, your statement is correct * * * we were getting assets in the portfolio whereas that man (the minority stockholder of a controlled company) only had a share of stock in the company, and he could never get assets for it. By combining all the shares together we got the assets.

Chase Donaldson, one of the original sponsors of The Equity Corporation and the president of Distributors Group, Incorporated, which controlled Allied-Distributors, Inc., the company which on a commission basis actively solicited acceptance of The Equity Corporation's exchange offers, testified with reference to the terms of that corporation's exchange offers (Public Examination, The Equity Corporation, at 10933):

> Q. * * * That really recapitulates the whole underlying technique or development of The Equity Corporation picture. It was either increasing the assets of The Equity Corporation by virtue of the fact that the underlying securities that they acquired in exchange for the Equity stock had a greater asset value or that the leverage factor in The Equity Corporation was increased. Isn't that so?
> A. That is correct.

[15] Mr. Odlum testified that he would "welcome some public body or arbiter who could pass on the equities as between divergent interests in such matters as mergers, reorganizations, and exchanges of securities, not to substitute their judgment for that of the management but to see that things are at least within the range of upper and lower limits within which reasonable men can properly differ" (op. cit. supra, note 2, at 18254). The testimony of Harold C. Richard, at present a director of Manufacturers Trust Company in New York City, to the effect that in his opinion the existence of an independent governmental agency with power to pass on the fairness of exchange offers would be desirable, has also been quoted at length elsewhere in this chapter. See supra, pp. 1334–6. See also the testimony of Chase Donaldson, infra, p. 1428.

[16] Op. cit. supra, note 10, Part I, pp. 411–5; and Sec. V, infra.

corporation. In fact, these individuals usually solicited acceptance of the exchange offers.[17] In the few cases where protective committees were organized, they succeeded in obtaining ultimately a better offer of exchange.[18]

As a practical matter, therefore, minority stockholders would have to take individual rather than collective action with reference to an exchange offer. The stockholder, in the first instance, therefore, would have to form his own conclusion as to the merits of the offer. Normally large numbers of stockholders would not have the financial experience which would be a prerequisite to an intelligent appraisal of the exchange offer.

a. Use of Services of Sponsors of Acquired Investment Companies

Obviously the first resource of a minority stockholder would be to seek the advice of the original sponsor of his company, its prior management, or the original distributor of the company's securities from whom the stockholder purchased the security.[19] The stock-

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[17] See supra, Sec. III.

[18] For example, the protective committee for the preferred stockholders of Atlantic and Pacific International Corporation succeeded in obtaining a more favorable exchange for their securities from Consolidated Funds Corporation than other preferred stockholders had obtained from Morris Plan Corporation. See supra, pp. 1125–36. Another instance of the power of stockholders by united action to obtain better terms for their securities than those offered generally to stockholders appears in the case of Atlas Corporation's exchange offer for the preferred stock of American, British & Continental Corporation. Early in 1932, Atlas Corporation acquired from the sponsors of American, British & Continental Corporation, J. Henry Schroder Banking Corporation, and Blyth & Company, 62% of the negative asset value common stock and a small block of the preferred stock and debentures of American, British & Continental Corporation at a total cost of $1,374,233 (op. cit. supra, note 2, Commission's Exhibit No. 2001, p. 202). During 1932 and 1933 Atlas Corporation made a series of exchange offers of its own securities for the preferred stock of American, British & Continental Corporation. In each of the exchange offers, the asset value of the securities of Atlas Corporation offered was substantially less than the asset value of the preferred stock of American, British & Continental Corporation (id., Commission's Exhibit No. 2001, pp. 202–4). The Boston investment banking firm of Preston, Moss & Co. advised several of its clients who held the preferred stock of American, British & Continental Corporation that in its opinion the exchange offers of Atlas Corporation were not "entirely equitable" (Public Examination, American, British & Continental Corporation, at 4880). E. G. Preston and others "independently volunteered" to form a protective committee and, in a letter sent out in July 1932 to a list of preferred stockholders of American, British & Continental Corporation who were clients of Preston, Moss & Co., stated that the offers of Atlas Corporation were "unattractive" (id., at 4881). As a result of conferences between members of this committee and Atlas Corporation, the latter agreed in March 1934 to purchase the holdings of the preferred stock of American, British & Continental Corporation held by the 35 stockholders represented by the committee at a price of $30 a share (id., at 4882–4). At the time of the purchase by Atlas Corporation the asset value of the preferred stock of American, British & Continental Corporation was $36 a share but its market value in an inactive market was only $21 a share (id., at 4883–5). In contrast, preferred stockholders of American, British & Continental Corporation who accepted the exchange offers of Atlas Corporation received securities having an asset value ranging from $12.36 to $14.06 less than the asset value of their stock (op. cit. supra, note 2, Commission's Exhibit No. 2001, at 203, 206).

[19] The history of Eastern Utilities Investing Corporation which was controlled throughout most of its existence by Associated Gas and Electric Company contains an illustration of the use of the services of the bankers who had originally distributed the company's securities to the public, to solicit exchanges of such securities for securities of another company. In March 1929, Harris, Forbes & Company and Halsey, Stuart & Co., Inc., both of which were investment banking firms, distributed to the public $35,000,000 face amount of debentures of Eastern Utilities Investing Corporation on the representation that the investment company would invest the proceeds of the issue in the purchase of

holder presumably had confidence in the integrity and ability of such individuals. Every effort was made to employ original sponsors and underwriters to solicit and to recommend acceptance of the exchange offers.[20]

In several cases the sponsors or managers of investment companies to be acquired did not solicit exchanges on behalf of the acquiring corporation.[21]

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a portfolio of diversified securities. Instead, however, the proceeds of the debenture issue were invested in the purchase from Associated Gas and Electric Company and its affiliated companies of the securities of such companies and of companies which subsequently became subsidiaries of Associated Gas and Electric Company. By the close of 1931, these securities of Associated Gas and Electric Company and its controlled and affiliated companies, which comprised virtually the entire portfolio of Eastern Utilities Investing Corporation, had substantially depreciated in value. At this point the Associated Gas and Electric Company inaugurated a series of exchange offers which continued until 1936 of its own debentures and other securities for the debentures of Eastern Utilities Investing Corporation. In connection with these exchange offers, Associated Gas and Electric Company employed Halsey, Stuart & Co., Inc., and Harris, Forbes & Company on a commission basis to solicit the acceptance of these exchanges by the debenture holders of Eastern Utilities Investing Corporation. The soliciting letters sent by the bankers to the debenture holders of Eastern Utilities Investing Corporation did not reveal the fact that Associated Gas and Electric Company was paying the bankers for their services. Eventually, Associated Gas and Electric Company, as the result of its exchange program, succeeded in acquiring nearly all of the outstanding debentures of Eastern Utilities Investing Corporation. See Ch. II of this part of the report, pp. 624–775.

[20] Mr. Odlum testified (op. cit. supra, note 2, at 18037–8 and 18227–8):

> Q. You always found, did you not, Mr. Odlum, that in these exchange programs the most effective instrumentality was the original sponsor or the underwriter who knew where the stock was and was familiar with the situation?
> A. Normally, that would be the case unless he had fallen into such disrepute his clients had disappeared.
>
> * * * * * * *
>
> Q. There was a pretty constant campaign carried on, was there not, particularly by the sponsors, to have these exchanges effected? Isn't that so? They had personal solicitation by their salesmen?
> A. Whenever they could manage it, they did it.
> Q. Letters were sent out?
> A. I don't know of any but probably so.
> Q. Did you make available to these more active exchanges the stockholders' lists?
> A. I think we [sic] already had them anyway.

[21] In one case an influential director of one of the Atlas Corporation's controlled companies refused to solicit transfers of shares to Atlas Corporation on a commission basis unless he was permitted to disclose the fact that he was receiving commissions from Atlas Corporation. As a result, the transaction was not consummated. On December 31, 1931, Ralph Jonas, a director of The Goldman Sachs Trading Corporation, sold to Atlas Corporation the 430,000 shares of the capital stock of The Goldman Sachs Trading Corporation (op. cit. supra, note 2, Commission's Exhibit No. 2001, p. 315), which constituted the remainder of his holdings of approximately one million shares of such stock which he had acquired in exchange for his dominant stock interest in Financial and Industrial Securities Corporation which had been merged with The Goldman Sachs Trading Corporation in 1929. Mr. Jonas had been the sponsor and president of the Financial and Industrial Securities Corporation and presumably had a substantial influence with the stockholders of The Goldman Sachs Trading Corporation who had formerly been stockholders of Financial and Industrial Securities Corporation. Mr. Jonas testified (Public Examination, Financial and Industrial Securities Corporation, at 19029–30):

> Q. In connection with the sale of the stock of Goldman Sachs by you to Atlas Corporation through Mr. Odlum, the negotiations regarding that lasted some time; initially you requested $3.50 a share and imposed the conditions the same opportunity be given to other shareholders?
> A. I told Mr. Odlum I would take $3.50 if he would make the same offer to the other stockholders. The thing dragged along. I had always taken the position in the F & I, I would not sell my interest unless there was some provision for the other stockholders. Incidentally, since it has come out that Mr. Odlum did pay a commission to other people, I might say he offered me 50 cents a share and I told him I had never made one penny off the stockholders of Goldman Sachs Trading Company or Financial and Industrial Securities Corporation, and while I would like to have the million dollars that that commission represented, I did not feel that I could go into the transaction without telling the stockholders I was making the deal and that if I told them I was making the deal I did not think he would get much stock.

However, in a great many cases, sponsors, directors or the original distributors of the securities of acquired investment companies recommended or actively solicited exchanges. In most cases, the advice of these individuals to minority stockholders may have been colored by the monetary consideration or other advantage which they received from the acquiring company. Yet, almost invariably the exchange offers never explicitly pointed out that these individuals were receiving any consideration for their recommendation of such offers.[22]

Sole reliance was not, however, placed by the acquiring corporation on solicitation of acceptance of its exchange offers by sponsors, directors or original distributors. General use was made of the services of bankers, commercial banks and brokers to aid in effecting its exchanges, for which services these institutions were compensated.

b. Use of Commercial Banks, Investment Bankers and Brokers

On June 4, 1932, Atlas Corporation made simultaneous offers of exchange to minority stockholders of 11 of its controlled companies. On June 14, 1932, a separate additional offer was made to the stockholders of The Goldman Sachs Trading Corporation. These offers were to expire on June 25, 1932. On June 14, 1932, and on June 24, 1932, Atlas Corporation addressed letters to virtually all the known commercial banks, investment bankers and brokers in the United States, offering to compensate them for their services in procuring

[22] For example, sponsors, directors, or original distributors of 10 of the 22 investment companies acquired by Atlas Corporation recommended its exchange offers. The following table indicates the name of the investment company and the name of the sponsors, directors, or original underwriters who recommended the Atlas Corporation exchange offers as well as the pecuniary advantages received by such individuals from Atlas Corporation (see supra, Sec. III, and op. cit. supra, note 2, Commission's Exhibits Nos. 1970, 2001) :

Name of company	Name of recommending individual	Connection with company	Pecuniary advan'age received from Atlas Corporation
1. All America General Corporation.	C. Shelby Carter, R. B. Scandrett, Jr., J. W. Campbell, H. C. Richard, C. H. Nichols.	Directors	$200,370.
2. Allied Atlas Corporation.	Board of directors		None.
3. Power and Light Securities Trust.	Hale, Waters & Co	Sponsors and underwriters.	Purchase price of warrants and commissions totaling $323,945.
4. Iroquois Share Corporation.	O'Brian, Potter & Co	do	Exchange of Iroquoi Share Corporation wa-s rants for Atlas Corporation warrants having market value of $50,212.50.
5. Federated Capital Corporation.	P. H. Whiting & Co	Original distributors	$160,000 in commissions.
6. General Empire Corporation.	Hemphill, Noyes & Co.	Sponsors and underwriters.	Commissions in amount not disclosed by the record.
7. Jackson & Curtis Investment Associates.	Jackson & Curtis	Sponsor and distributor.	None.
8. National Securities Investment Co.	A. G. Becker & Co., Inc.	do	Commissions totaling $50,000.
9. Sterling Securities Corporation.	Schoellkopf, Hutton & Pomeroy, Inc.	One of original distributors.	Commissions totaling $2,916.25.
10. Atlantic Securities Corporation.	A. Iselin & Co. F. S. Smithers & Co.	Sponsors, original distributors.	Purchase of warrants for $150,000.

exchanges.[23] The names of the banks, bankers, and brokers were obtained from published lists and directories of these organizations. The Atlas Corporation letters to these institutions enclosed copies of its exchange offers and further stated:

Undoubtedly you will receive a number of requests from your clients for information on Atlas Corporation and on the exchange offer. To compensate you for the trouble and expense which you may be put to in handling such inquiries we offer to reimburse you as follows for each share of the following stock * * * which may be forwarded by you to the depositories as specified in the exchange offers for the account of your customers:

	Cents
All America Corporation	20
Allied Atlas Corporation	20
American British & Continental Corporation preferred	10
Aviation Securities Corporation	20
Chain Store Stocks, Inc	12
Federated Capital Corporation preferred	25
General Empire Corporation	18
The Goldman Sachs Trading Corporation	5
National Securities Investment Company preferred	75
Securities Allied Corporation	15
Sterling Securities Corporation Convertible First preferred	50
Ungerleider Financial Corporation	50

The fact that compensation was to be received by these financial institutions for their efforts in obtaining exchanges was not revealed to the stockholders of the controlled companies in the exchange offers.[24] In addition, inquiries of stockholders made to Atlas Corporation or to any of its controlled companies as to the merits of the exchange offers were answered with a suggestion that the stockholder obtain the advice of their bank, banker, or broker upon the merits of the offer.[25] But these letters in answer to stockholders' queries likewise did not reveal the fact that Atlas Corporation was compensating financial institutions for recommending exchanges. That a substantial number of exchanges were effected through the medium of financial institutions is indicated by the fact that the commissions paid by Atlas Corporation pursuant to its letters of June 14 and June 24, 1932, totaled $465,202.[26]

Mr. Odlum, when examined on the commissions offered to financial institutions for their effectuation of exchange offers, testified:[27]

Q. You will remember whenever anybody wrote to the Atlas Corporation to ask about the fairness of the offer, Atlas refused to give any advice. Isn't that so?

A. That is correct.

Q. If a stockholder of a trust wrote in to his own trust and said, "Should I accept the offer," his own trust refused to give any advice, because the Board of Directors of his own trust were the Board of Directors of the Atlas Corporation; isn't that so?

A. I think it is probably true.

[23] Op. cit. supra, note 2, Commission's Exhibit No. 1970.
[24] Ibid.
[25] Id., at 18226–7.
[26] Id., at 17794.
[27] Id., at 18226–7.

Q. * * * The statement you made was that they ought to go to their private dealer or banker to ascertain whether the exchange was fair. Yet it is true, is it not, that virtually every bank and broker, at least potentially, had a pecuniary interest in effecting these exchanges; isn't that so?

A. Slightly; yes.

Q. So that * * * there was nobody to whom the stockholder could go to ask for a really completely unbiased or unprejudiced opinion upon the equitableness of the exchange? Isn't that so?

A. I think Moody's and Poor's and other investment sources had publicly recommended acceptance.

Q. But you can visualize, can you not, if he went to his own broker, unless there was a disclosure by the broker that he made a half dollar per share in the exchange, that the broker was in a position that if he did not recommend the exchange he would lose the commission; isn't that so?

A. Yes; to the same degree that a broker might advise his clients to sell a stock just to get a commission. It is practically a brokerage commission.

The Equity Corporation in connection with its exchange program also contacted large commercial banks in which it maintained deposits or with which it had some friendly business relationships and requested the officers of the banks to recommend to their customers and depositors acceptance of The Equity Corporation's exchange offers.[28]

c. Personal Solicitation by Sponsors and Dealers

Efforts to obtain exchanges went further than the mere circularization of stockholders of the investment companies to be acquired. Sponsors and dealers were retained to engage in direct personal solicitation of security holders to effect the exchange, a method which constituted in many instances a most important component of the exchange technique. The original sponsors or distributors of the securities of acquired companies were paid commissions at a

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[28] For example, in a letter to a stockholder of one of The Equity Corporation's subsidiaries who had requested information as to The Equity Corporation's exchange offer, David Milton, the president of The Equity Corporation, stated (Public Examination, The Equity Corporation, Commission's Exhibit No. 1032).

> You can inquire with regard to the managing personnel of The Equity Corporation from any of the usual sources, such as large New York banks. The banks where the officers are well known will include Chase National Bank, Central Hanover Bank and Trust Company, Manufacturers Trust Company, and National City Bank.

In each of these banks mentioned by Mr. Milton, The Equity Corporation had deposits of its funds or other business relationships (id., at 10698). On June 22, 1933, Samuel W. Anderson, an officer and director both of The Equity Corporation and Interstate Equities Corporation, wrote William A. Whiting of the Bankers Trust Company of New York as follows (id., Commission's Exhibit No. 1027):

> I notice that there are a number of stockholders of Interstate Equities Corporation registered care of the Bankers Trust Company. I am attaching a list of them.
> The Equity Corporation has recently sent a communication to the stockholders of Interstate in reference to the possible exchange of shares. I am enclosing some copies of this communication. I would like to feel that the Bankers Trust Company would handle this situation not strictly in a routine way, and could perhaps make some effort to help us to overcome the natural inertia of people in connection with matters of this kind. I wonder if you could get me on the right track with regard to this or in any other way give us a boost. I would certainly appreciate it if you would.

Mr. Whiting replied (id., Commission's Exhibit No. 1028):

> This is to let you know that I have received your letter enclosing copies of your circular addressed to stockholders of Interstate Equities. I will be glad to look into the matter and see what we can do to get in touch with these people. I will find out who in the bank could be most helpful, and will communicate with you the early part of next week.

higher rate than those paid to other dealers presumably because of their importance and effectiveness.[29]

In the investment bankers and security dealers who had transferred control of their companies an efficient machinery was found for a nation-wide personal solicitation of exchanges, since these investment bankers had offices and dealer connections throughout the United States. In addition to soliciting the stockholders of the companies which they had themselves organized, these dealers were employed on a commission basis to solicit actively exchanges of the securities of all other controlled investment companies.[30] Exclusive territories in which to pursue solicitation of exchanges were apportioned to these dealers.[31]

These brokers and security dealers conducted aggressive campaigns to effectuate exchanges by means of personal solicitation of stockholders. "Pink slips" containing the names of prospective exchanging stockholders were distributed to their salesmen in all of their branch offices.[32] Memoranda were distributed urging salesmen to concentrate on securing exchanges.[33]

It is obvious that the stimulus of these "pep notices" and the desire to earn commissions might tend to induce salesmen to adopt tactics inconsistent with fair dealing to stockholders. In the course

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[29] Thus, dealers as a class received a commission of 75¢ for each share of the preferred stock of National Securities Investment Company preferred stock which they succeeded in procuring by exchange of Atlas Corporation securities. A. G. Becker & Co., Inc., the sponsor of National Securities Investment Company, received $2 per share of the preferred stock of National Securities Investment Company, which by its efforts was exchanged for Atlas Corporation stock. Mr. Odlum testified (op. cit. supra, note 2, at 18037):

> Q. * * * Do you remember why this discrepancy of 75¢ for everybody else and $2 for Becker occurred?
> A. * * * The reason why 75¢ was broadcast to every banker and broker in the United States was to do the mechanical work to help the client get the stock in. A. G. Becker & Co., we expected them to give active help in getting the stock in.

Mr. Odlum also testified (id., at 18225–6):

> Q. In some instances the original sponsor or distributor of securities got more than this amount [paid generally to banks and brokers]; isn't that so?
> A. Yes.

[30] Thus, Hemphill, Noyes & Co. solicited acceptance of all Atlas Corporation exchanges as well as acceptance of exchanges for the securities of General Empire Corporation, the Atlas Corporation controlled company which it had sponsored. The territory within the reach of the salesmen of Hemphill, Noyes & Co. was wide. The firm maintained branch offices and employed salesmen in New York, Detroit, Toronto, Ithaca, Philadelphia, Trenton, Washington, D. C., Boston, Bridgeport, Buffalo, Albany, and Pittsburgh. P. H. Whiting & Co. which had originally distributed the shares of Federated Capital Corporation had contacts with 125 security dealers throughout the United States and Canada. A. G. Becker & Co., Inc., a Chicago investment banking firm, solicited exchanges throughout the state of Illinois (id., Commission's Exhibits Nos. 1982, 2036, 2037 [Item 8]).

[31] A. G. Becker & Co., Inc., was awarded Illinois as its exclusive territory in which to solicit exchanges of the first preferred stock of Sterling Securities Corporation; Hemphill, Noyes & Co. solicited exclusively the exchange of such securities in New England; and Schoellkopf, Hutton & Pomeroy, Inc., one of the original distributors of the Sterling Securities Corporation first preferred stock, was granted the remainder of the United States as its territory for the solicitation of exchanges (id., Commission's Exhibit No. 2036).

[32] Id., Commission's Exhibit No. 2037 (Items 2–12 and 47).

[33] Typical examples of these memoranda are the slips entitled "Just Between Ourselves" or more shortly "J. B. O.'s" issued by Hemphill, Noyes & Co. during the pendency of the June 4, 1932, simultaneous exchange offers made by Atlas Corporation for the securities of 11 of its controlled companies:

> This is a fine opportunity for you to cover your entire list [of customers and clients] in a whirlwind drive, offering service on their exchanges and at the same time checking up as to just how things stand with each customer, whether he is in the market

of these personal solicitation campaigns salesmen used tactics which might be deemed unfair.

Salesmen exaggerated the performance of the management of the acquiring corporation.[34]

In some instances representations were also made by salesmen that the exchange offers had been approved by the courts.[35] Solici-

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for anything else, if not, when he will be, whether he would care to trade in commodities.

* * * * * * *

Plunge into this work, let nothing deter you. Get these shares in for exchange and do it at once. This is a way for you to build up your bonus credits and make June a brilliant month (J. B. O., June 17, 1932).

July 15 is the last day for the Atlas exchanges unless the time is extended which is not at all probable. Speed is now the essence of things if we are to make the quick money offered us by securing deposits of these various stocks. * * * (J. B. O., July 7, 1932).

A number of offices have now been able to advise us that they have covered and reported on every pink slip sent them on any exchange.

Where the work has not been completed it should be pressed vigorously tomorrow. The last day for the exchange is Friday, July 15 (J. B. O., July 12, 1932).

Mr. Odlum, though he testified that he knew Hemphill, Noyes & Co. was "working" on the exchanges, stated that he had never seen these memoranda, which he characterized as "typical pep notices" (id., at 18230).

[34] For example, emphasis was placed by salesmen upon the fact that Atlas Corporation had started with $40,000 and had in 1932 attained control of assets valued at $58,000,000. A letter dated December 20, 1932, addressed to a stockholder of Securities Allied Corporation by a Hemphill, Noyes & Co. salesman, stated (id., Commission's Exhibit No. 2037 [Item 19]):

So that you may have the facts before you I am giving you herewith a résumé of the Atlas Corporation which is the outgrowth of an enterprise that was started in 1923 with $40,000 capital and as of August 31, 1932, reported controlled assets of more than $58,000,000.

The inference might be drawn from the statement that the increase in the value of the assets controlled by Atlas Corporation had been the product solely of appreciation in the original assets of the company rather than the result largely of additional capital contributions. Mr. Odlum testified (id., at 17524–5):

Q. Now in order to dispel—well should I characterize it as a myth which I know you have not propagated—but there is no intimation that the $40,000 through appreciation and earnings became the $110,000,000, the present size of Atlas Corporation?

A. That is right.

Q. You have heard that?

A. I have heard it.

Q. Of course there is no basis of fact for that?

A. None whatever. We have 80,000 stockholders today and the original people own a very small part of the capital.

Q. So that a substantial part of the Atlas Corporation was capital and surplus derived from people who subsequently purchased the stock?

A. That is correct.

Q. * * * The fact is that the $40,000 was not through your management developed or grown into a hundred million dollars.

A. That is correct.

[35] Thus, a letter written on November 25, 1932, to a stockholder of Securities Allied Corporation by a salesman employed by Hemphill, Noyes & Co. stated:

It may interest you to know that the Supreme Court of the State of New York, in the case of a defunct company which is in the hands of a receiver, had this proposition of the exchange of Securities Allied for Atlas Corporation put up to it last week and has just rendered a decision recommending the exchange to be made.

A letter written to the same stockholder on December 23, 1932, again stated:

I was astounded when I called you yesterday to learn that Mr. * * * had recommended that you hold your Securities Allied stock as it is a well known fact that many of New York's best bankers, attorneys, and accountants have recommended this exchange of stock, said exchange having even been recommended by the Supreme Court of the State.

Similar representations were made to other Securities Allied Corporation stockholders by salesmen.

Mr. Odlum testified that he had "never heard" of the decision of the New York Supreme Court mentioned by the salesmen. Even if such decision existed, obviously it could not be construed as a general approval of the exchange offer. In the winding up of the affairs of a "defunct" corporation, liquidation of its assets for as high an immediate cash consideration as possible would be the motivating rationale of the court's decision. Since the market value of the Atlas Corporation securities offered for the stock of Securities

tors also attempted to create the impression that substantial numbers of stockholders had approved of, and had accepted exchanges.[36] Similarly, dealers soliciting exchanges induced exchanges on the false representation that the acquiring corporation would declare, in the near future, a large dividend on its common stock.[37] Stockholders were informed that they would sustain substantial losses if the exchanges were not immediately accepted.[38]

These illustrations indicate the type of pressure exerted by salesmen in their personal solicitation of exchanges. Such activities on the part of salesmen are largely uncontrollable. Little attempt was made by the acquiring corporations to supervise the activities of solicitors.[39]

Allied Corporation slightly exceeded the market value of such stock, the court would order the exchange and the sale of the Atlas Corporation securities. Certainly such a decision if it had existed should not be cited as a general recommendation of the exchange offer to all investors (op. cit. supra, note 2, at 18232 and Commission's Exhibits Nos. 2001, 2037 [Items 1, 18, 20]).

[36] Thus, one stockholder of The Goldman Sachs Trading Corporation was informed in July 1932 that less than 600 stockholders of that company had not exchanged their shares for Atlas Corporation shares. The stockholder upon inquiry made to Goldman, Sachs & Co., the original sponsor of The Goldman Sachs Trading Corporation, was informed "that the statement made to you to the effect that there remained less than 600 stockholders who have not yet exchanged their stock is believed to be very far from the facts. According to our present stock list there are in the neighborhood of 40,000 registered stockholders; while it is impossible to tell at this time how many have exchanged their shares we feel safe in saying that there are many thousands who are retaining their Goldman Sachs stock, representing an ownership, we feel certain, of over 4,000,000 shares."

In another instance a stockholder of Chatham Phenix Allied Corporation was informed in a letter dated November 16, 1932, written by a Hemphill, Noyes & Co. salesman, that "we recommend the exchange of the Chatham Phenix stock and while it is difficult to recite in full in a letter the reasons for the recommendation, the fact that in excess of 90% of the stockholders have already made the exchange, speaks for itself." In fact, however, of the 1,434,057 shares of the stock of Chatham Phenix Allied Corporation ultimately acquired by Atlas Corporation only 679,948 shares, or 47.4% of Atlas Corporation's total holdings in the stock, were acquired by exchange offers (op. cit. supra, note 2, Commission's Exhibits Nos. 1962, 1963, 1985, 2037 [Item 17]).

[37] The Equity Corporation through Allied-Distributors, Inc., one of its affiliated companies, also conducted an extensive personal solicitation campaign with reference to its exchange offers. Lists of the stockholders of the subsidiaries of The Equity Corporation were supplied to Allied Distributors, Inc. which in turn distributed them to local dealers who received commissions for their services in inducing exchanges. An effort was made to procure the services of the dealer who had originally sold the securities of the subsidiary companies to the stockholders (Public Examination, The Equity Corporation, at 10538–40, 10562, 10904–5 and Commission's Exhibit No. 1064). For a more detailed discussion of the personal solicitation campaign conducted by The Equity Corporation, see op. cit. supra, note 10, p. 235, et seq.

A stockholder of one of The Equity Corporation's subsidiary investment companies was induced to exchange his stock on the false representation that The Equity Corporation would shortly declare a 10% dividend on its common stock (Public Examination, The Equity Corporation, Commission's Exhibit No. 1040).

[38] One of the dealers informed a stockholder of Interstate Equities Corporation that she "would be compelled to turn over my 40 shares of Interstate Equities preferred stock" for stock of The Equity Corporation and that "all is over" if the exchange was not made and that "I have no more hope after Wednesday, October 31st." Mr. R. Sherwood Elliott, the secretary of The Equity Corporation, agreed that these and other instances of dealer tactics "clearly indicated the security dealers did bring pressure" (id., at 10781 and Commission's Exhibit No. 1042).

[39] Mr. Odlum testified that he was unaware of these practices engaged in by salesmen (op. cit. supra, note 2, at 18230).

As this Commission has stated in another report to the Congress: "There is no gauging the pressure which house-to-house canvassers, thus employed, will bring to bear to induce

2. INDUCEMENTS TO EXCHANGE

The average investor is usually confused by and often suspicious of any offer of exchange made to him by a hitherto unknown financial group. The tendency is for the investor to procrastinate or to refuse to accept such offers. This inertia must be overcome if the exchange program is to be successful. Various practices to overcome this resistance to exchange offers were employed [40] and subtle pressures to induce exchanges were devised. Some of these practices will be described.

a. Time Limits for Acceptance of Exchange Offers

The offers of exchange were always limited in duration and contained statements which implied that unless stockholders accepted the offers within the short time limits allotted, no further opportunity would be afforded to stockholders of controlled companies to accept such offers. Nevertheless it was the intent of the acquiring corporation to continue to effect exchanges until they had acquired the percentage of the outstanding shares of a controlled company necessary to effect its dissolution, consolidation, or merger. In fact, the offers were almost always extended and, in some cases, renewed and again extended.[41] But the determination of whether or not to renew or extend the offers rested solely with the acquiring corporation. Stockholders who received offers were not informed of the decision to extend or renew such offers until the expiration date of the original offer had passed. However, salesmen and solicitors were informed in advance of the decision to extend the offers.[42]

Mr. Odlum testified that the purpose of not revealing the intent of Atlas Corporation to extend the exchange offers was to prevent a "slowing up" of exchanges.[43] The necessity for a short time period for

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security holders to deposit with a committee or to assent to a plan" (op. cit. supra, note 10, Part I, p. 487). Mr. Odlum testified (op. cit. supra, note 2, at 18232):

> Q. We are interested in what we call the pressure devices.
> A. Yes; they all raise a question. I think in England they have a law that nobody can solicit any stock or sell stock from door to door.

[40] For a discussion of the inducements used by The Equity Corporation to effect exchanges, see op. cit. supra, note 10, p. 266, et seq.

[41] Public Examination, The Equity Corporation, Commission's Exhibit No. 839; and op. cit. supra, note 2, Commission's Exhibit No. 1970.

[42] Thus, a "J. B. O." dated June 24, 1932 (the day before the original expiration date of Atlas Corporation June 4, 1932, offers to stockholders of 11 of its controlled companies) addressed by Hemphill, Noyes & Co. to its salesmen stated:

> Atlas * * * does not care to announce in advance whether the extension will be made but we gain the impression that it almost certainly will. Therefore continue to make every effort to get these stocks sent in to us for exchange (op. cit. supra, note 2, Commission's Exhibit No. 2037 [Item 5]).

[43] Mr. Odlum testified (id., at 18231):

> Q. Now let me ask you this question, Mr. Odlum. In order to speed up the exchanges it would not be disclosed if it was the intent of Atlas Corporation to extend the time of exchanges? That would not be disclosed because that might slow up the exchange?
> A. That is correct.
> Q. That is part of the technique?
> A. Even though we thought we were going to extend we never said so until the last minute.

The June 4, 1932, exchange offers (id., Commission's Exhibit No. 1970) made by Atlas Corporation simultaneously to the holders of the securities of 11 of its controlled companies afford an example of the use of this technique. All of these offers stated:

> If you desire to accept this offer, you must, ON OR BEFORE THE CLOSE OF BUSINESS ON JUNE 25, 1932 (or on or before the close of business on such extended date or dates not later than July 15, 1932, as may be specified by Atlas * * * Corporation) execute the enclosed letter of transmittal * * *.

acceptance was attributed, in the offers, to the differences in capital structures of the various controlled companies and the effect of such structural differences on the asset values of the various securities involved in the offer. The "leverage" in the capital structure of the acquiring company and its beneficial effect on the asset value of its common stock in the event of a rising market was also urged as a reason for limiting the offer period. There was created the impression that nonacceptance of the offer within the period might result in financial loss to the stockholder receiving the offer and that he would be given no further opportunity to effect an exchange for the common stock of the acquiring corporation.[44] No reference was usually made to the fact that a decline in the value of the assets of the acquiring corporation would, because of the "leverage" in its capitalization, cause a proportionately greater decline in the asset value of its common stock.[45]

The efficacy of time limitations for acceptance of exchange offers is indicated by the following statement in a memorandum addressed by Hemphill, Noyes & Co., one of the soliciting agents for Atlas Corporation to its salesmen on January 23, 1933:[46]

> In four days last week after it was known that no more exchanges of Securities Allied into Atlas could be arranged after Saturday, 20,000 shares came in or were promised for delivery early this week. Could there be better proof of what a group of determined salesmen can do when they desire to * * *?

Notwithstanding the statement in this memorandum that exchange offers made by Atlas Corporation for the stock of Securities Allied Corporation were terminating in January 1933, Atlas Corporation continued until July 1933 to repeat its offers of exchanges for such stock.[47]

b. Control of Market Prices of Shares to be Exchanged

The ratio of securities to be involved in exchange offers were calculated largely upon the market values of the securities involved in the offers. Nevertheless, to a substantial extent this basis of calculation—the market values of the respective securities—was usually under the control of the acquiring corporation. For example, during the pendency of its exchange offers, made on June 4, 1932, agents of Atlas Corporation made at least some effort to stabilize the market price of

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[44] Thus, in the June 4, 1932, offer of Atlas Corporation to the stockholders of Securities Allied Corporation, the following typical statement was made (id., Commission's Exhibit No. 1970):

> The changes upward and downward of the portfolios of different companies affects the stocks of such companies to different degrees because of differences in capital structure. Your company, for example, has only common stock outstanding, whereas Atlas * * * Corporation has outstanding both common and preference stock. Therefore, in the event of increase in the value of portfolio holdings the asset value of Atlas * * * Corporation common stock because of the "leverage" provided for it by the outstanding preference stock, will increase comparatively more rapidly than increase in the value of such portfolio * * *. Under such circumstances this offer must be limited to a short period of time.

[45] Despite the difference in the capital structure of Atlas Corporation and of Securities Allied Corporation and of the changes "upward and downward in the value of the portfolios" of the companies, the Atlas Corporation offer of June 4, 1932, to the stockholders of Securities Allied Corporation was extended to July 15, 1932, and renewed on identical terms on September 23, 1932, March 16, 1933, June 13, 1933, and July 12, 1933 (id., Commission's Exhibit No. 1970).

[46] Id., Commission's Exhibit No. 2037 (Item 12).

[47] Id., Commission's Exhibit No. 1970.

Atlas Corporation's securities. Moreover, prior to, and at the time of its June 4, 1932, offers of exchange to the stockholders of its subsidiaries, control of which had been acquired in 1931 or early in 1932, Atlas Corporation was substantially the only determinant of the market prices of the securities of such companies.

Before the succession of Atlas Corporation to control of its various subsidiaries, the market in their securities, particularly after the stock market crash of 1929, had been maintained and supported only by the purchases of the corporations themselves or by their sponsors and managers.[48] However, Atlas Corporation on its accession to the management of these companies immediately terminated their market-supporting activities. In the agreements whereby it acquired control, Atlas Corporation also usually obtained a stipulation from the former sponsors or managers[49] requiring them to cease any market activities in the securities of their corporations. Many of the sponsors became brokers for Atlas Corporation, bidding for the shares of their former companies at prices fixed by Atlas Corporation.[50] As a result Atlas Corporation became substantially the only market bidder for the securities of these investment companies.[51] Atlas Corporation usually set market prices for its subsidiaries' stocks which were slightly in excess of the market prices of comparable investment company securities (which fact may have induced the sale of such securities to Atlas Corporation) but nevertheless were at a substantial discount from their asset value.[52] The determination of the extent of the spread between the market and asset values of the securities was largely in the hands of Atlas Corporation.

(1) GREATER MARKET VALUE OF ATLAS CORPORATION SECURITIES OFFERED IN EXCHANGES

Prior to its June 4, 1932, simultaneous offers of exchange to the stockholders of 11 of its then controlled companies, Atlas Corporation had in most cases been the determinant of the market price of these securities for substantial periods of time.[53] In the June 4, 1932, offers, however, the market value of the Atlas Corporation securities obtainable by exchanges exceeded the then market values of the securities of its controlled investment companies.[54] The increased cash values to be obtained for these securities as a result of the terms of the exchanges would induce many stockholders who wanted to liquidate their holdings to exchange their securities for Atlas Corporation securities even though such exchange entailed a loss in asset values. Mr. Odlum conceded that the higher market value of the Atlas Corporation shares would be a motivating factor in the decision of many stockholders to accept the exchanges.[55]

Q. Now in connection with one of the essential elements of the acquisition program namely, to acquire assets at a discount it was essential that some

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[48] See Sec. III, supra, particularly pp. 1099, 1144–5, 1308 and 1311–12.

[49] Ibid.

[50] Ibid.

[51] Derived from supplementary information supplied the Commission for Atlas Corporation.

[52] Op. cit. supra, note 2, at 17772–3, 18014–6.

[53] Op. cit. supra, note 48.

[54] Op. cit. supra, note 2, Commission's Exhibit No. 2001

[55] Id., at 17771–2.

compensatory feature be added in order to induce the exchanges. A person isn't going to give you a dollar in asset value for 80 cents in market value unless you give him something which he considers or which you think he would consider makes up the difference, isn't that so?

A. That is correct, or putting it more direct if he had a dollar that at the moment was only worth 80 cents to him then he wouldn't sell it for 80 cents but he might sell it for ninety cents, so that he got more, ten cents more and we got ten.

Q. Or the situation might be that if he had a dollar but he couldn't lay his hands on the dollar immediately he would be prepared to take eighty cents if he could realize that 80 cents immediately?

A. Yes; it is comparable to a man who bought a piece of land for a dollar, and the best he could get for the land was 80 cents, although he considered and felt that the land was still worth a dollar, and somebody came along and offered 90 cents for the land and he would say "That is better than I can get elsewhere; I am sacrificing ten cents but I am making ten cents."

Atlas Corporation, during the pendency of its offers, maintained a bid in the market for its subsidiaries' securities. However, Atlas Corporation would prefer to obtain its subsidiaries' shares by exchange rather than by purchase for the reason that the market value of Atlas Corporation's common stock offered in its June 4, 1932 exchange offers substantially exceeded its asset value. The market price of Atlas Corporation's common stock on June 4, 1932 was $5 per share; its asset value was only $2.97 per share.[56] Atlas Corporation would gain in assets to a greater extent by exchanges than it would by purchases of its subsidiaries' securities. Financial institutions soliciting exchanges for Atlas Corporation therefore made every effort to obtain an exchange of a subsidiary company's securities. Mr. Odlum testified:[57]

Q. These people [the soliciting agencies] were using various plans to get these stocks out of the hands of the * * * holders. If they could not exchange them, they would buy for cash, and if they could not buy them, they would tell them to sell on the [stock] exchange, all with the intent to get those stocks exchanged for Atlas shares, isn't that so?

A. That is correct.

In some cases at least dealers attempted to purchase for Atlas Corporation's account the shares of stockholders who refused to make an exchange at prices less than the market value of the Atlas Corporation securities offered in exchange. Only as a last resort was an effort made to induce stockholders to sell their shares on an organized securities market where, as a result of the terms of the offers the market prices of the securities would tend to equal those of the Atlas Corporation securities obtainable on the exchange offer. An example of this type of activity on the part of dealers is reflected in the agreement (which has been fully described elsewhere in this chapter[58]) between Atlas Corporation and Schoellkopf, Hutton & Pomeroy, Inc., with reference to the solicitation by that firm of the preferred stock of Sterling Securities Corporation. Briefly summarized, the agree-

[56] Id., Commission's Exhibit No. 2001.
[57] Id., at 18228.
[58] See supra, pp. 1177–8.

ment required the Schoellkopf firm, if it failed to effect an exchange to attempt to purchase the Sterling Securities Corporation preferred stock at a price one dollar less than the market value of the Atlas Corporation stock offered in exchange. Only if a purchase at this price could not be made was the Schoellkopf firm to attempt to prevail upon the stockholder to sell his stock on the New York Stock Exchange where it would "presumably come into" Atlas Corporation's hands.[59]

(2) NONMARKETABILITY OF SUBSIDIARIES' SHARES

Generally the securities of controlled companies did not enjoy a broad and active market. Usually the only activity in the market for such shares would result from the acquiring corporation's purchases. Substantial purchasing by the acquiring corporation would increase activity in the market for such shares and therefore would tend to raise their market prices. As a consequence, the acquiring corporation sometimes refrained from entering the market. In the absence of such purchases the market would usually become thin, few trades would appear in the daily price quotations, and the price would recede. In short, the investment company making the exchange offers was to a large extent the determining factor in the activity in the market for its subsidiaries' securities.

On the other hand, the securities of the acquiring company usually enjoyed a broad and active market on a securities exchange because of the wide distribution of the corporation's shares effected by its exchange offers. To those stockholders of subsidiary companies who desired to liquidate their holdings, the superiority of the market in the securities of the acquiring company would stimulate their acceptance of the exchange offers.[60]

As the exchange program progressed and the acquiring company accumulated a large proportion of the securities of its controlled companies, the thinness of the market in such securities was accentuated. In many cases the absence of an adequate distribution of the shares in the hands of the public led to their delisting by the securities markets upon which they were traded. For example, Mr. Odlum testified that the gradual contraction in the marketability of the shares of Atlas Corporation's controlled investment companies, as the public holding of such shares was diminished, would serve to induce the remaining stockholders to exchange their shares:[61]

Q. Of course, on this marketability, Mr. Odlum, when you get into this period certainly there was no market because Atlas Corporation in most instances had 90% or 95% of the stock?

A. No. As a matter of fact, several of them were delisted because of the small public holding. The market in most cases was only an Atlas market.

Q. That little holdout group, for instance, although you said sometimes as a matter of nuisance value they came out better than the fellow who played along but he has a sense of futility, hasn't he?

A. Yes.

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[59] Op. cit. supra, note 2, Commission's Exhibit No. 2036.

[60] For example, in its June 4, 1932, offers Atlas Corporation referred to the "comparatively narrow market" in its subsidiaries' stocks and to the "broader" market in its own securities (id., Commission's Exhibit No. 1970).

[61] Id., at 18231–2.

Q. He has no market.

A. No.

Q. And if he does not take the Atlas stock he may feel he has a valueless piece of paper and that was another impetus to effect exchanges? Isn't that so?

A. I think so.

In this situation, virtually the only manner in which a stockholder could liquidate his holdings was to accept the exchange offer.[62] Salesmen soliciting exchanges also stressed the inactivity of the market in the stock of controlled companies and the possibility of a delisting of their securities.[63]

(3) STABILIZATION OF MARKET PRICE OF SECURITIES OF ACQUIRING CORPORATIONS DURING EXCHANGE PERIODS

Since the superior marketability and market value of the stock of the acquiring corporation involved in the exchange offers were substantial factors which would induce exchanges, it would clearly be advantageous to the acquiring corporation if the market value of its securities increased or at least remained approximately constant during the pendency of its exchange offers. A drop in the market value of its securities would destroy the attractive ratio of market values which stimulated the acceptance of exchanges by stockholders of acquired companies. Moreover, normally the increased supply [64] of the acquiring corporation's securities which would appear on the market

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[62] The exchange offers made by Atlas Corporation subsequent to June 4, 1932, emphasized the superior marketability of Atlas Corporation's securities. Thus an offer addressed to the stockholders of Securities Allied Corporation on September 23, 1932, stated:

> Only approximately 28,000 shares of Securities Allied Corporation have been traded in on the New York Curb market since July 15, 1932 (the date of the expiration of our offer). During the same period approximately 450,000 shares of common stock of Atlas Corporation were similarly traded in.

An offer to the stockholders of Federated Capital Corporation on the same date contained the following statement:

> So far as we can ascertain only approximately 2,600 preferred shares and 400 shares of common stock of Federated Capital Corporation have been traded in the market since July 15, 1932 (the date of the expiration of our offer). During the same period approximately 450,000 shares of common stock of Atlas Corporation were bought and sold. The stock of the Federated Capital Corporation remaining outstanding in the hands of the public is so small that the market for such shares will, in the future, probably be inactive (id., Commission's Exhibit No. 1970).

[63] A letter written on December 17, 1932, by a salesman employed by Hemphill, Noyes & Co., to a Securities Allied Corporation stockholder stated:

> The number of shares of Securities Allied stock still outstanding is very small, since the market has dwindled to practically nothing and it is opportune to state here that because of this small market there is always the possibility that the shares will be stricken from the Curb Exchange.

Another letter dated November 23, 1932, written by a salesman to a stockholder of Ungerleider Financial Corporation stated:

> It may be of interest to you to know that your Ungerleider stock was withdrawn from trading on the New York Curb which should considerably lessen its marketability.

Still another letter written on December 7, 1932, to a stockholder of Securities Allied Corporation stated:

> The number of shares of Securities Allied outstanding is being lessened constantly with the result that you have a materially lessened market activity and public interest in the stock. As a consequence, Securities Allied stock will not be in a favorable market position to reflect any enhancement in value (id., Commission's Exhibit No. 2037 [Items 14, 15, 16, 35]).

[64] During 1932, Atlas Corporation issued in connection with its exchange offers over 78,000 shares of its preference and 1,135,000 shares of its common stock (op. cit. supra, note 2, Commission's Exhibit No. 1959).

as a result of the acceptance of exchanges would tend to cause a decline in their market value.

During the period of time allotted for acceptance of the offers of exchange the market prices of the securities of the acquiring corporation would be stabilized. For example, elsewhere in this chapter [65] there has been described how Chase Donaldson and his associates, with the aid of Atlas Corporation, were enabled to procure a loan of the funds needed by them to acquire control of Allied General Corporation in January 1932—a loan guaranteed by Atlas Corporation and secured by a controlling block of the stock of Allied General Corporation. At the time of acquisition of control of Allied General Corporation, it was also informally decided that Allied General Corporation would attempt to aid Atlas Corporation in its expansion program by purchasing on the market Atlas Corporation stocks and exchanging them by means of a personal solicitation campaign carried on by its salesmen and dealers, for the securities of the investment companies controlled by Atlas Corporation. Mr. Donaldson testified: [66]

Q. Substantially what was the arrangement you had with the Atlas Corporation with respect to these exchanges?

A. I have been trying to refresh my own mind on what the arrangement was, but as nearly as I can determine from looking over the correspondence and the records, the Atlas Corporation advised us they would be willing to purchase from time to time the stock of their subsidiary and affiliated companies, and they had no objection to our offering Atlas common which we might purchase in the market or over the counter, in exchange for such stock, and that if we became long these subsidiary and affiliated stocks their disposition was to purchase them from us at no definite set of prices that I can recall. That was the general tenor of the arrangement. I don't recall that there were any specified prices that were ever reduced to writing, although that was the general intent of it, and as I looked over the books we from time to time sold them some of our various subsidiary and affiliated stock for cash, against which we had delivered to dealers Atlas Corporation preferred and common which we had purchased in the open market.

Sustained purchase of Atlas Corporation securities by Allied General Corporation on the New York Curb Exchange, on which the Atlas Corporation's securities were listed, would tend to support and maintain the price of such securities, especially where no counterselling on the market by Allied General Corporation took place. As Mr. Donaldson testified, the Atlas Corporation securities acquired in the market were disposed of over the counter by exchanging them for the securities of Atlas Corporation's controlled investment companies.

During the month of May 1932, a month prior to the simultaneous offers of exchange made by Atlas Corporation to the stockholders of its subsidiaries, 5,200 shares of Atlas Corporation preferred stock were traded in on the New York Curb Exchange. The price of the stock during the month ranged from a high of 35 to a low of 32½ per share. In this month Allied General Corporation purchased through broker members of the New York Curb Exchange a total of 4,600

[65] See supra, pp. 1351–7.

[66] Public Examination, Allied General Corporation, at 5245–6.

shares of Atlas Corporation preference stock or approximately 90% of the total of such shares traded in on the New York Curb Exchange. During the course of the month, Allied General Corporation disposed of only 440 shares of the stock, which were sold to or through Moore & Schley, a brokerage firm which does a substantial amount of the brokerage business of Atlas Corporation. During the same month the volume of trading in the common stock of Atlas Corporation on the New York Curb Exchange totaled 76,600 shares. Allied General Corporation's market purchases of the stock during the month totaled 68,347 shares. In the same period only 100 shares were sold and these shares were sold over the counter to or through Moore & Schley as brokers.[67]

Manifestly, the activity in the market and the market prices of the shares of Atlas Corporation during the month of May 1932 were substantially a reflection only of the trading in such securities by Allied General Corporation. That Atlas Corporation was cognizant of these purchases by Allied General Corporation is apparent from the fact that the purchases to a substantial extent were made for the account of Atlas Corporation and that loans were made by Atlas Corporation to Allied General Corporation presumably to enable it to carry on its activities. Thus, the minutes of the meeting of the Executive Committee of Allied General Corporation, held on May 12, 1932, state:[68]

> Whereas, Atlas Corporation does not desire to make settlement prior to May 22, 1932, on 2,664 shares of its preferred stock and 32,409 shares of its common stock purchased for its account but is willing to make a loan to Allied General Corporation in the amount of $200,000 * * * said moneys to be applied on said purchases when due:
>
> Now, therefore, be it resolved that it is in the best interests of this corporation to increase its cash position by accepting this loan against future deliveries * * *.

The minutes of a meeting of the same committee on May 26, 1932, state:[69]

> Whereas, Atlas Corporation does not desire to make settlement prior to June 1, 1932, of its obligations amounting to approximately $406,000 on 1,826 shares of its preferred stock and 65,000 shares of its common stock purchased for its account by Allied General Corporation but is willing to make an additional loan to this corporation in the amount of $150,000 * * * said moneys to be applied when due against said purchases * * *.
>
> Now, therefore, be it resolved that it is to the best interests of the Corporation to increase its cash position by accepting this loan against future deliveries * * *.

As has been stated, on June 4, 1932, Atlas Corporation made simultaneous exchange offers to the shareholders of 11 of its existing controlled companies. The Atlas Corporation preference stock, it was stated in the offers, had a then market value of $34 per share; the market value of the common stock was stated in the offers to be $5 per share. The offers, however, did not reveal the extent of the pre-

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[67] Op. cit. supra, note 2, Commission's Exhibit No. 2037 (Item 26).
[68] Ibid.
[69] Ibid.

vious market activity of Allied General Corporation in these securities.[70]

The offers made on June 4, 1932, ultimately expired on July 15, 1932.[71] During the entire period that these offers were in existence the market prices of Atlas Corporation's securities remained approximately equivalent to those which were stated in the offers. The price of the preference stock fluctuated within a two-point range; the high for the period was 34¼ and the low 32. The common stock of Atlas Corporation also fluctuated within a narrow range, the high for the period being 5½, the low 4⅜.[72]

From May 1 to the end of July 1932, Allied General Corporation purchased through member brokers on the New York Curb Exchange a total of 9,100 shares of the preference stock of Atlas Corporation.[73] The total volume of trading in the stock on the Curb Exchange during these months was 9,900 shares. In other words, Allied General Corporation's purchases constituted 92% of the purchases on the New York Curb Exchange for the period. Only 100 shares were sold in the market by Allied General Corporation during these months and only 440 shares were sold over the counter by Allied General Corporation. The great bulk of the shares acquired by Allied General Corporation were resold to Atlas Corporation. From June to August 3, 1932, Atlas Corporation purchased from Allied General Corporation 8,425 shares of the 9,100 shares of preference stock which the latter had accumulated. The shares so purchased by Atlas Corporation were reissued to stockholders of its controlled companies who had accepted its June 4, 1932, offers.[74]

Simultaneously, Allied General Corporation engaged in extensive market purchases of the common stock of Atlas Corporation. The stabilizing effect of these purchases was not counteracted by any substantial sales by Allied General Corporation in the open market.[75] The following figures[76] indicate the total market purchases and sales of the common stock of Atlas Corporation made by Allied General Corporation in May, June, and July 1932, and compares such activity with the total volume of trading in such stock on the New York Curb Exchange in the same months.

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[70] Id., Commission's Exhibit No. 1970.

[71] Ibid.

[72] Id., Commission's Exhibit No. 2037 (Item 26).

[73] Id., Commission's Exhibit No. 2037.

[74] Ibid. and id., Commission's Exhibit No. 2002, p. 24.

[75] Mr. Chase Donaldson, the president of Allied General Corporation, testified (Public Examination, The Equity Corporation, at 10544):

> * * * Now I don't know of my own knowledge of any specific exchange program that is comparable as to what The Equity Corporation was going on in this period. In the case of Atlas Corporation where we worked for a few months, we, in general, conducted the program much along the same lines as I have outlined for you for The Equity Corporation, where we did purchase and sell Atlas common stock and preferred in the market as a stabilizing influence.

[76] Op. cit. supra, note 2, Commission's Exhibit No. 2037.

Month	Total volume of trading on New York Curb Exchange	Market purchases by Allied General Corporation	Percentage of Curb volume represented by purchases of Allied General Corporation	Market sales by Allied General Corporation
May 1932	76,600	68,347	89	
June 1932	47,125	32,100	68	
July 1932	27,100	14,000	52	500
Total	150,825	114,447	76	500

Of the 114,447 shares of Atlas Corporation's common stock acquired by Allied General Corporation, 101,207 shares were resold to Atlas Corporation, which distributed them in fulfilment of its exchange offer commitments:[77] 2,102 shares were disposed of in over-the-counter transactions;[78] and, as indicated in the above schedule, 500 shares were disposed of on the market. The records do not indicate what disposition Allied General Corporation made of the balance of 10,638 shares which it had purchased. Presumably they were used by Allied General Corporation and its dealers in exchange for the shares of the companies controlled by Atlas Corporation.

The market prices of The Equity Corporation's common and preferred stocks were also stabilized during the course of its exchange program. As in the case of the subsidiaries of Atlas Corporation, the stocks of the companies controlled by The Equity Corporation had only a thin market.[79] In some cases the nonmarketability of the securities of the subsidiaries of The Equity Corporation was accentuated by their delisting from the securities exchanges on which they had previously been listed.[80] In other words, the security holders of the subsidiaries of The Equity Corporation were deprived of any organized market for their securities.

On the other hand, the common stock of The Equity Corporation was listed on the New York Curb Exchange[81] and such stock was actively traded in by Distributors Group, Incorporated, and Allied-Distributors, Inc., two companies headed by Chase Donaldson. During the period in which The Equity Corporation's exchange offers were in effect, Distributors Group, Incorporated and Allied-Distributors, Inc., engaged in extensive redistribution operations in both the common stock and the preferred stock of The Equity Corporation. The stocks of The Equity Corporation were purchased in the open market and redistributed to investors through dealers. In other words, the stabilizing influence of the market purchases made by Distributors

[77] Id., Commission's Exhibits Nos. 2002 (pp. 57-8) and 2037.

[78] Id., Commission's Exhibit No. 2037.

[79] Public Examination, The Equity Corporation, Commission's Exhibits Nos. 1034, 1035.

[80] For example, on May 3, 1933, the Detroit Stock Exchange delisted the securities of Yosemite Holding Corporation, one of the subsidiaries of The Equity Corporation. The delisting was occasioned by the fact that the officers and directors of Yosemite Holding Corporation who had been selected by The Equity Corporation had removed the Detroit transfer agent and registrar of the stock of Yosemite Holding Corporation. (Letter dated August 8, 1936, from the Detroit Stock Exchange to the Securities and Exchange Commission.)

[81] Op. cit. supra, note 79, Commission's Exhibit No. 1037.

Group, Incorporated and Allied-Distributors, Inc. was not impeded by resales of the purchased securities on the open market. Mr. Donaldson testified:[82]

A. * * * In the entire Equity program our efforts were more directed towards securing some degree of stability and of redistributing stock that went from exchanges rather than to materially influence the price of either the preferred or common.

* * * * * * *

Q. Now then, as I understand it, you say that the basic motive of the trading in the Equity stock was not one for profit that you could make by virtue of the trading but was, shall we say, to take up the stock which went back into the market and to maintain the price on an even keel. What would you say fundamentally was the purpose of the account of the Allied Distributors and the Distributors Group in the Equity common and preferred stock?

A. Well, I should say that your statement is correct. The fundamental purpose was to absorb the stock, Equity common and preferred, that was resold by people who had accepted the exchanges, and the reason that a substantial amount was resold was that in many instances the securities in question either had no market or a very inactive market and the shareholders of those companies had not been able to realize any fair market for their securities. Secondly, when it became possible for them to exchange an inactive or illiquid or other security that they hadn't been able to dispose of for The Equity Corporation which did have a market by reason to some extent of our purchases and sales, there was a tendency to liquidate on the part of some of them and there also arose as it always does between old and new securities arbitrage operations on the part of street traders where they would purchase Interstate Equities Corporation preferred and turn it in for Equity preferred and common * * * and that reached considerable volume at different periods and if the period was to continue it was desirable to us essentially that there was somebody available to pick up the stock and resell this stock to dealers. That was the primary motive.

During 1935, Distributors Group, Incorporated, and Allied-Distributors, Inc., bought a total of 915,095 shares of the common stock of The Equity Corporation both in and off the New York Curb Exchange and sold 1,032,363 shares of such stock. Their purchases on the New York Curb Exchange amounted to 289,100 shares and constituted nearly one-half of the total volume of 636,700 shares of The Equity Corporation common stock traded on the New York Curb Exchange during the year 1935. In fact, during April, May, and June of 1935, purchases by Distributors Group, Incorporated, represented as much as approximately 61%, 73%, and 81%, respectively, of the total volume of trading on the New York Curb Exchange in the common stock of The Equity Corporation. The great majority of the sales by Distributors Group, Incorporated, and Allied-Distributors, Inc., were made over the counter to dealers who resold them to distributors on a commission basis. Only 200 shares were resold on the New York Curb Exchange.[83]

This market for The Equity Corporation's common stock was, as Mr. Donaldson conceded, a "factor" which induced many of the stock-

[82] Id., at 10544–6.

[83] Id., Commission's Exhibits Nos. 1019, 1021.

holders of The Equity Corporation's subsidiaries to exchange their stocks for the securities of The Equity Corporation:[84]

Q. Now one observation you made, Mr. Donaldson, was that persons may have been persuaded to enter the exchange by virtue of the fact that there was a market in The Equity Corporation while there was no market——

A. No market or a poor market.

Q. Or a poor market in the securities which were being exchanged. The effect of that was, then, that one of the possible convincing forces was the presence of an orderly market in the Equity stock which Allied Distributors was making. One resultant consequence was that by virtue of the fact that you had that orderly market, the securities were being sold, thereby increasing the amount of distribution that Allied Distributors would have to make in that stock?

A. There is no question about the fact that there was a market in Equity Corporation stock and there wasn't for the Yosemite Holding Corporation. It was a factor in inducing some of the holders to exchange, and I believe I mentioned the nonexistence of markets more as indicating the possibilities of arbitrage and the fact that a flow back was bound to be generated because of that situation. It is a little hard to try to analyze just what proportion of holders may have exchanged by reason of such a differential. I should say that some proportion, but I would not think it was a substantial proportion that was influenced by that factor.

The active market and the stabilized price of the securities of The Equity Corporation may have been a material factor in the decision of stockholders of The Equity Corporation's subsidiaries to accept its exchange offers. Nevertheless, The Equity Corporation did not reveal to exchanging stockholders its activity in the market in its own stock.[85]

c. Refusal to Liquidate Controlled Companies—Evaluation of Assets of Controlled Companies

Generally the asset values of the securities of the controlled investment companies computed on the basis of the market value of their portfolio securities exceeded both the market value and the asset value of the acquiring corporation's securities offered in exchange for such shares. Only infrequently, however, as will be seen, was the disparity between the asset values of the securities of the acquiring corporations and the controlled companies' securities indicated in the solicitation literature.[86] These disparities were in part sought to be

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[84] Id., at 10548–9.

[85] Securities Registration Statement, Form A–1, filed by The Equity Corporation with the Federal Trade Commission February 10, 1934 (later transferred to the Securities and Exchange Commission). Post-effective amendments to this registration statement, filed July 17 and July 20, 1937, disclosed for the first time the market activity in the stocks of The Equity Corporation of Allied-Distributors. Inc.. and Distributors Group. Incorporated.

[86] In the June 4, 1932, offers of exchange made by Atlas Corporation, the disparity between the asset values of the securities of controlled companies and the market value of the Atlas Corporation securities offered in exchange was revealed (op. cit. supra, note 2, Commission's Exhibit No. 1970). In the exchange offer circulars issued prior to June 4, 1932, the asset values of the securities of the companies controlled by Atlas Corporation were not revealed (ibid.).

overcome in the solicitation literature by an appeal to the "leverage" advantage of the acquiring corporation's common stock.[87]

The realization by the acquiring corporation of these disparities in the asset and market values of the securities involved in the exchanges was of the essence of expansion programs. Stockholders of controlled companies who did not desire to suffer these asset losses had no alternative but to await the dissolution, merger, or consolidation of their companies with the acquiring corporation. In the case of a dissolution they would receive their pro rata distributive share of their corporation's assets; in the case of a merger or consolidation informed stockholders could dissent to the merger or consolidation and could assert their statutory right to receive the appraised value of their shares.

However, the acquiring corporation was the sole factor in the determination of the time and manner in which it would absorb the assets of its controlled companies. At the time of its exchange offers the acquiring corporation usually held, as a result of its original transaction with the sponsors or managers of its controlled companies, at least enough of the outstanding voting stock of its controlled companies to prevent the dissolution of such companies without its consent,[88] and would, of course, refuse to liquidate its controlled companies until it had acquired, by exchange or purchases, substantially all of the outstanding shares of its controlled companies. The power of the acquiring corporation to prevent a dissolution of its acquired investment companies acted as a strong pressure upon stockholders of the controlled companies to accept exchanges. Stockholders who desired to realize on their holdings of the securities of controlled companies had virtually no choice but to accept the exchange offers or to sell their shares to the acquiring corporations. As Mr. Odlum testified:[89]

A. To bring it down to what we are talking about—assuming that he [a stockholder of a controlled company] had a stock that had back of it asset value of a dollar, and his stock had a market value of 70¢, he could very well take the position that intrinsically, on an appraisal of assets, his stock was worth a dollar, but his stock being only one of a million shares, and his stock therefore, as a share of stock, is only worth what he can sell it for on the market. * * *

Q. But the Atlas Corporation hoped to make its money or build up its cushion * * * through the technique of getting assets and giving in return market value; isn't that so?

A. We were getting something—essentially your statement is correct—we were getting assets in the portfolio whereas that man only had a share of stock in the company and he would never get assets for it. By combining all the shares together we get the assets.

Q. Your answer is based on your conclusion that he could not get the assets. We will come to specific cases in which there were no legal impediments to his getting the assets.

A. In many cases there was none, but he couldn't require the liquidation.

Ultimately, of course, Atlas Corporation intended to liquidate or consolidate its controlled companies. However, its exchange offers usually made no mention of this fact. The annual report of Atlas

[87] The use of "leverage" as an argument for acceptance of exchange offers will be discussed later.

[88] Op. cit. supra, note 2, Commission's Exhibit No. 2001; and the cases supra, Sec. III.

[89] Op. cit. supra, note 2, at 17773–4.

Corporation for the year ending 1931 which accompanied its June 4, 1932, exchange offer [90] did make reference to the expansion program of Atlas Corporation although the report did not clearly indicate the eventual intent to simplify the Atlas Corporation corporate structure by means of the legal processes of dissolution, merger, or consolidation.

In at least one case Atlas Corporation refused to liquidate one of its controlled companies in order to provide the stockholders of such company with an opportunity to obtain the asset value of their shares as an alternative to acceptance of its exchange offer. On June 4, 1932, Atlas Corporation owned approximately 60% of the outstanding capital stock of Aviation Securities Corporation.[91] On that date Atlas Corporation offered to exchange one and two-fifths shares of its own common stock having a total market value of $7 for each share of the capital stock of Aviation Securities Corporation. The letter containing the offer stated that the asset value of each share of Aviation Securities Corporation capital stock was $12.20 per share.[92] Aviation Securities Corporation stockholders who accepted the offer would thus suffer a loss of $5.20 per share of their holdings measured by the difference between the asset value of their shares and the market value of the Atlas Corporation securities offered in exchange. Moreover, the shares of Atlas Corporation offered in exchange had a then asset value of $4.16, a fact not revealed in the soliciting literature.[93] On the basis of the comparative asset values of the securities involved in the offer, accepting Aviation Securities Corporation stockholders would suffer a loss of $8.04 per share of their Aviation Securities Corporation stock.

A committee of the independent directors of Aviation Securities Corporation headed by Laurance H. Armour, president of the corporation, attempted to secure a better offer from Atlas Corporation or, failing in that, to obtain the consent of Atlas Corporation to a dissolution of Aviation Securities Corporation.[94] Atlas Corporation refused either to better its exchange offer or to dissolve the corporation.[95]

On July 1, 1932, Aviation Securities Corporation addressed a circular letter, signed by Mr. Armour and written with the knowledge and consent of Atlas Corporation, to the stockholders of Aviation Securities Corporation informing them of the fruitless efforts of the company's independent directors to obtain a better offer or to induce Atlas Corporation to effect a dissolution of the corporation. This letter stated: [96]

> Following the issuance by Atlas Corporation of its offer of June 4th, the Directors of your Company recently conferred with the management of Atlas Corporation in order to ascertain whether the latter company would agree to the liquidation of your Company in view of the fact that the assets of your Company, with a few exceptions, are either cash or immediately capable of liquidation in the market. At this conference the management of Atlas Corporation indicated that it acquired and enlarged its interest in your Company because of

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[90] Id., Commission's Exhibit No. 1943.

[91] Id., Commission's Exhibit No. 1970. For the method by which Atlas Corporation acquired control of Aviation Securities Corporation, see supra, pp. 1270–8.

[92] Op. cit. supra, note 2, Commission's Exhibit No. 1970.

[93] Id., Commission's Exhibits Nos. 1970, 2001.

[94] Id., Commission's Exhibit No. 1970.

[95] Ibid.

[96] Ibid.

the business in which your Company was then engaged and which it expected your Company to continue; and that accordingly it did not desire or agree to the liquidation of your Company, stating that "the liquid position of the Company has no bearing on the question of liquidation, liquidity being purely a question of policy in the continuing management of an investment trust."

Mr. Odlum testified that he was opposed to the liquidation of Aviation Securities Corporation because it was his intention to consolidate the corporation with Atlas Corporation.[97] Within approximately one year after the date of the letter, Aviation Securities Corporation was dissolved by Atlas Corporation, which then had acquired 97% of the outstanding stock of Aviation Securities Corporation.[98] Atlas Corporation had acquired 37% of its holdings as the result of exchange offers and purchases made after the date of the letter indicating to Aviation Securities Corporation stockholders the improbability of a dissolution of their company.[99]

Clearly the letter, in suggesting that Aviation Securities Corporation would be a continuing enterprise, conceivably would stimulate exchanges of Aviation Securities Corporation shares for Atlas Corporation shares. The inability of the Aviation Securities Corporation stockholders to obtain the asset value of their stock by compelling the dissolution of their corporation and the suggested non-immediate prospect of an early dissolution of their company by Atlas Corporation would induce them to sell or exchange their shares for Atlas Corporation shares.

Salesmen of brokers and dealers soliciting exchanges also represented that dissolution of any of the controlled companies was improbable. This representation was used largely to overcome resistance to the exchange offer by stockholders who believed their shares had a "nuisance value" to Atlas Corporation or who desired to await the liquidation of their companies. A typical letter[100] written by a salesman employed by Hemphill, Noyes & Co. on December 17, 1932, to a stockholder of Securities Allied Corporation contains the following statement:

Many of these few remaining shareholders seem to feel that at some time their stock will have a so-called nuisance value. Nothing is farther from the truth. Atlas will not and does not have to buy these shares. They now

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[97] Id., at 18084–5. Mr. Odlum testified:

A. * * * At the time of the * * * June 4, 1932 offer the directors of the Aviation Securities Corporation felt that our offer was not liberal enough to their stockholders, and they sent a delegation down to New York of their directors to argue the matter out with us, and they went into facts and figures with us and presented their arguments and we presented our argument, and both remained somewhat firm in position; and they went back to Chicago and sent a letter to their stockholders saying that they had been down to see us and had tried to get a better offer but had not succeeded in getting a better offer but that the facts that we had stated were right.

Q. Reading from Commission's Exhibit No. 1970, a letter dated July 1, 1932, signed by Laurance H. Armour, there were strong indications that a committee had been appointed to confer with Atlas Corporation and requested Atlas Corporation by virtue of the liquid condition of Aviation Securities Corporation to liquidate the corporation. Isn't that so?

A. Yes. I believe so.

Q. Had Atlas Corporation opposed the liquidation?

A. Yes.

Q. And do you know why?

A. Because at that time we thought we were going to bring that company in in our general consolidation * * *.

[98] Id., Commission's Exhibit No. 2001 (p. 85).

[99] Ibid.

[100] Id., Commission's Exhibit No. 2037 (Item 14).

control Securities Allied and can liquidate it if and when they please, which, however, seems improbable. In the meantime you are holding a security with practically no market and chances for appreciation such as Atlas has.

The character and ultimate value of the assets of the controlled companies would also stimulate stockholders of such companies to exchange their shares rather than to await the dissolution of their companies. As has been indicated elsewhere in this chapter,[101] most of the investment companies acquired by Atlas Corporation became participants in its program. Their portfolios of diversified securities were liquidated and their funds reinvested, under the direction of Atlas Corporation, in the securities of other investment companies which were then controlled by Atlas Corporation or the control of which Atlas Corporation intended to acquire. In other words, the portfolios of many of the subsidiary investment companies were eventually composed, to a substantial extent, of the securities of other companies controlled by Atlas Corporation, the market values of which were substantially less than their asset values. As a consequence, the asset value of the shares of the controlled companies, if computed on the basis of the market value of their portfolios, was in many cases substantially less than would have been the case if the asset values of such shares were computed on the basis of the asset values of the shares of other Atlas Corporation controlled companies in their portfolios.

Stockholders of the controlled companies were not informed of the change in the investment policies of their companies until they received the 1931 year-end annual reports [102] of their companies. In some cases not until the exchange offers made by Atlas Corporation on June 4, 1932, did minority stockholders become aware of the change made by the Atlas Corporation management from the previous investment policies of their companies. The June 4, 1932, exchange offers made by Atlas Corporation simultaneously to all of its then subsidiaries, however, revealed the extent to which the investment policy imposed by Atlas Corporation upon its subsidiaries had affected the value of their securities. The offers pointed out the differential between the asset value of the shares of controlled companies, if computed upon the basis of the market value of their portfolios and if computed on the basis of the underlying asset values of the securities of other controlled companies included in their portfolios.

Thus, the offer made on June 4, 1932 to the shareholders of Securities Allied Corporation stated:

As of the date of this letter, the indicated asset value of the stock of your Company is approximately $8.50 per share. If the holdings of stocks of your Company in affiliated investment trusts are appraised at their asset values rather than their market values, this figure would be increased by approximately $4.75 per share.

In the case of Allied Atlas Corporation the similar differential in the value of each share of the company's stock depending on the method of evaluation was revealed as $6; in the case of General Empire Corporation the differential in value was declared to be $2.50 per share. In other cases the dollar amount of the differential between the asset

[101] See supra, pp. 1059–63.

[102] Op. cit. supra, note 2, at 18235.

value of the company's shares on an evaluation of its portfolio at market or at underlying asset value was not given but it was pointed out that it existed. Thus, the June 4, 1932, exchange offers to the stockholders of All America General Corporation stated: [103]

As of the date of this letter the indicated asset value of the stock of your company is approximately $7.65 per share. If the holdings of stock of your company in affiliated investment trusts are appraised at their asset value rather than the market value, this figure would be substantially increased.

In this situation a stockholder who elected to await the dissolution of his company rather than to accept the exchange offer might receive as his cash distributive share of his company's assets only his pro rata portion of such assets calculated on a market-value basis.[104] Atlas Corporation, on the other hand, would receive as its distributive share of the controlled company's assets, calculated upon the same basis of market value, the securities of other as yet undissolved controlled companies having asset values substantially higher than their market values. And Atlas Corporation had the power to realize these asset values by dissolving or consolidating with itself the companies whose securities it had received on the dissolution of another controlled company.

Investment houses and salesmen soliciting exchanges sometimes stressed the fact that minority stockholders would receive on any liquidation of their companies only their pro rata share of the price at which the companies' assets were sold. A letter of this type, addressed to stockholders of General Empire Corporation by a salesman employed by Hemphill, Noyes & Co. stated: [105]

To you, as a minority holder of General Empire Corporation stock, we would point out that generally the minority interest in any investment trust subsidiary company is not in an advantageous position.

Atlas Corporation has acquired about 95% of General Empire and therefore controls the destiny of the trust. Should the management of Atlas ever decide to liquidate General Empire the amount payable to each share of stock will be whatever the liquidating value proves to be when the securities are sold. Nothing the individual stockholder can do or say will change that figure.

The contrast between the liquidating value of their shares if based on the market values of their companies' portfolio securities (the basis which presumably would govern their distributive shares on a dissolution of their companies) and if based on the underlying asset values of their companies' holdings of other Atlas Corporation controlled investment company securities, would induce many stockholders to accept the exchange offers made by Atlas Corporation. Only by becoming an Atlas Corporation stockholder would the shareholder of one of its controlled companies be certain of an opportunity to participate, at least partially, in the actual value of his company's assets. In addition, as a stockholder of Atlas Corporation, not only would the shareholder of a controlled company retrieve a portion of his own asset losses but he would also share to some extent in the asset losses of stockholders of other controlled companies which inured to

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[103] Id., Commission's Exhibit No. 1970.

[104] See infra, pp. 1446–57.

[105] Op. cit. supra, note 2, Commission's Exhibit No. 2037, Item 34.

the benefit of Atlas Corporation. In sum, the utilization by Atlas Corporation of the assets of such companies to further its investment trust acquisition program operated as an inducement to the participation and acquiescence in such program by many shareholders of the controlled companies, who hoped by becoming Atlas Corporation stockholders to recoup eventually all or a portion of their immediate asset losses.

3. SOLICITATION LITERATURE

Exchange offers of the type made by The Equity Corporation and Atlas Corporation are now within the provisions of the Securities Act of 1933. Under this Act a full disclosure of all relevant and material facts with reference to such exchange offers is required. Nevertheless, as the Commission has pointed out elsewhere: [106]

> Although offers to exchange securities of one company for the securities of another * * * are subject to the requirements of the Act, there are important types of voluntary plans which are not. For example, Section 3 (a) (9) of the Act specifically exempts securities "exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." [107] Furthermore, the registration and prospectus provisions of the Securities Act ordinarily are not applicable to mergers, consolidations, or sales of assets effected pursuant to the provisions of typical state statutes. Likewise, the powers of the Securities and Exchange Commission over the solicitation of proxies conferred by Section 14 (a) of the Securities Exchange Act of 1934 do not * * * extend to securities which are not traded on a national securities exchange.

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[106] See op. cit. supra, note 10, at 249–50.

[107] For example, in June 1934, General Investment Corporation offered to exchange $15 in cash and 7 shares of its common stock which had no asset value for each share of its preferred stock which then had an asset value of $95.64 a share although its market value was only $15 a share. The exchange offer circular written by the company's management did not disclose either the market or the asset value of the securities involved in the exchange. Furthermore, the retirement of substantial blocks of the investment company's preferred stock at a cost less than the actual liquidating value of such shares would increase the possibility of participation in the company's assets and earnings of the common and Class A common stockholders of the company. The common stock and Class A common stock of General Investment Corporation then had no asset value. At the time of the exchange offer the United Founders Corporation group of investment companies, which was in control of General Investment Corporation, held 50,000 shares of the Class A stock and 148,780 shares of the common stock of General Investment Corporation, or approximately 27% of the aggregate of such common and Class A stock then outstanding. The letter stating the terms of the investment company's exchange offer for its own preferred shares did not indicate the management's holdings of the common and Class A common stock of the company and the possible benefit which might accrue to the management by virtue of their holdings if the offer was successful.

On the date of the exchange offer the market value of the preferred stock was approximately $15 a share and the market value of the company's common stock was 75 cents a share. On a market value basis, therefore, the company's offer of $15 in cash, plus 7 shares of common stock having a market value of $5.25, for each share of its preferred stock was an attractive one.

As a result of its offer, General Investment Corporation reacquired 42,337 shares, or one-third of its outstanding preferred stock, having a total asset value of $4,029,110. For these shares General Investment Corporation expended $635,055 in cash and issued 296,359 shares of its common stock, without any asset value at that time. As a consequence, the asset value of the remaining preferred stock was enhanced by approximately $3,414,055 at the expense of the preferred stockholders who had accepted the company's offer.

As a result of these and similar exchange offers made by General Investment Corporation for its own preferred stock in 1934 and 1935, the company reacquired 63,711 shares

The great majority of existing investment trusts and investment companies do not have their securities listed upon national securities exchanges.[108] As a consequence the merger, consolidation, and sale of assets of these companies are subject to no administrative supervision, and the problem of the solicitation material used in connection with exchange offers is therefore still of importance.

a. "Leverage"

Some exchange offers revealed the fact that the market value of the securities of the acquiring corporation offered in exchange was substantially less than the asset value of the securities whose exchange was being solicited. To overcome the revealed disparities between the market value of the securities of the acquiring corporation offered in exchange and the asset value of the securities of the controlled companies, the "leverage" advantage in the acquiring corporation's common stock in the event of a rising securities market was represented as a compensating factor. Not disclosed, however, was the disadvantage of "leverage" in the case of a falling securities market.

"Leverage" has been defined in Part One, Chapter II (page 28) of this report as the designation given to investment companies "which have outstanding senior securities with fixed or relatively fixed maximum participations in the corporate assets and earnings. Because these claims, while having precedence over the rights to the company's assets belonging to the holders of the common stock, yet are to fixed or only slightly variable amounts of money, any increase or decrease in the value of the total assets of a leverage company will be reflected in its entirety in the equity of the common stock. As a consequence, a given change in the total assets will give rise to a more than proportionate change in the equity of the common stock. * * * 'Leverage' is measured by the ratio of the total assets of the company to the asset value of the common stock."

Thus the presence of "leverage" in the capital structure of an investment company produces, in a period of falling security prices, a decline in the asset value of the common stock of such companies relatively greater than the decline in the market value of the companies' total assets. For example, the leverage capital structure of Atlas Corporation and its adverse effect on its common stockholders in a falling market was one of the compelling forces which led to the inauguration of the corporation's program of acquiring, at a discount from their asset value, the assets of other investment com-

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of its preferred stock, or approximately one-half of such preferred stock outstanding prior to the exchange offers, at a discount of about $4,162,145 from their asset values at the approximate times of such offers. Largely as a result of the retirement of part of the investment company's preferred stock by exchange offers and the subsequent sale for $7,500,000 of a previously illiquid portfolio security held by the company, the net assets of the investment company as at November 30, 1936, were not only sufficient to meet the full liquidating preference of the then outstanding preferred stock of the company, but were also sufficient to provide an asset value of approximately 70 cents per share for the company's outstanding Class A and common stocks. In the meantime, however, the United Founders Corporation group of investment companies had sold their Class A stock and common stock of General Investment Corporation, which carried control of the company, to International Equities Corporation, then controlled by Ernest B. Warriner. (See Ch. II of this part of the report, pp. 497–623.)

[108] See Part Two (House Doc. No. 70, 76th Cong.), Ch. IV, pp. 279–84.

panies. At the close of 1929, Atlas Corporation had acquired in consideration for the issuance of its securities total assets having a value of approximately $17,000,000. There were outstanding 174,211 shares of preference stock entitled on liquidation to a prior claim against the corporation's assets to $50 per share, or a total prior fixed claim of $8,710,500. Therefore, the outstanding 938,683 shares of common stock were entitled to approximately one-half of the assets of the corporation. However, a fifty percent decrease in the corporation's total assets would wipe out the assets belonging to the common stock. And as has been previously indicated, Mr. and Mrs. Odlum, Mr. and Mrs. Howard, and Mr. Hatch, the founders of Atlas Corporation, had acquired, in 1929, 300,000 shares of the common stock of Atlas Corporation, or approximately one-third of the total common stock outstanding at the end of 1929.[109] The record does not indicate that they held any of the corporation's preference stock. The expansion program undertaken by Atlas Corporation by increasing the total corporate assets allocable to Atlas Corporation's common stock served to stem somewhat the effect of leverage upon the asset value of such stock. With the advent of falling securities prices, to increase the outstanding senior securities of Atlas Corporation would have brought into greater operation the downward effect of "leverage" in the assets allocable to the common stock. Consequently, in the program of investment company acquisitions engaged in by Atlas Corporation, its exchange offers of its securities were designed to require the issuance of a minimum of its preferance stock and a maximum of its common stock.[110] Many stockholders of controlled companies may have desired the Atlas Corporation preference stock since it was not subject to the harmful effect of "leverage" and also because the Atlas Corporation expansion program served to increase the asset coverage per share of preference stock.

The expansion program of Atlas Corporation thus had the effect of somewhat reducing in a falling market the adverse effect of its "leverage" capital structure upon the asset value of its common stock. The program also benefited the common stock in that it resulted in the acquisition at a discount from their actual value of the "leverage" and "nonleverage" stocks of other investment companies. Since these shares were acquired for a consideration less than their asset value, Atlas Corporation common stockholders were protected to that extent against a further drop in market prices, and if market prices increased, the asset values of the leverage stocks of other investment companies acquired by Atlas Corporation would, because of their leverage, rise proportionately higher than the value of the total assets of such companies. In effect, therefore, the expansion program enabled the Atlas Corporation common stockholders to balance in a falling market the harmful operation upon their shares of the leverage in Atlas Corpora-

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[109] See supra, pp. 1052–71.

[110] Most of the exchange offers involved only Atlas Corporation's common stock (op. cit. supra, note 2, Commission's Exhibit No. 1970). However, the exchange offers usually contained a postscript stating that "any shareholder who would prefer to exchange for $3 preference stock of Atlas Corporation rather than the Common Stock should communicate with the company" (ibid.). In other words, in order to obtain an offer of Atlas Corporation's preferred stock, the exchanging stockholder was required to take further steps.

tion's own capital structure against the possibilities of profit in a rise in the asset value of the "leverage" securities of other investment companies in the portfolio of Atlas Corporation.

That the expansion program of Atlas Corporation was designed to overcome the "handicap of leverage" was first revealed in the corporation's annual report on February 17, 1933, the date of the publication of the report for the year ending 1932. By February 17, 1933, Atlas Corporation had made virtually all of its exchange offers.[111] The report written by Mr. Odlum stated:[112]

> The Common Stock of Atlas Corporation is of a type known as "Leverage" stock, the leverage (which causes asset value of the common stock to rise or fall faster than the rise or fall in market price of the controlled assets) being supplied by the Preference Stock of Atlas Corporation, the debentures and preferred stock of Subsidiaries and the debentures and preferred stock of other investment trusts in which your Company and Subsidiaries have a common stock interest. Leverage is a great advantage to common stockholders in a period of rising prices and a distinct disadvantage in a period of falling prices. During the past three years your company (Atlas) has protected its common stockholders against the handicap of leverage by its program of expansion combined with liquidity.

Obviously, the disadvantage as well as the advantages of the phenomenon of leverage should be disclosed to stockholders, particularly those who hold nonleverage securities and are invited to accept an exchange of a leverage security for their own shares.

The "handicap of leverage" in a falling securities market was usually not disclosed in the exchange offers of their common shares made by acquiring corporations to the stockholders of their controlled companies. Rather, the leverage advantages of the common stock of the acquiring corporation in a period of rising security values was stressed as a compensating factor offsetting the losses in asset values suffered by stockholders of controlled companies who accepted the offers.

The "leverage" argument in favor of the common stock of the acquiring corporation was used against the capital stock of a nonleverage controlled company.[113] In the case of controlled companies having leverage capital structures the acquiring corporation, although conceding the leverage in the common stocks of such companies (which, however, usually were without asset value) pointed out the tremendous extent to which the corporation's assets would have to increase before the common stocks of such companies would acquire any asset

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[111] Ibid.

[112] Id., Commission's Exhibit No. 1943.

[113] The offer of exchange made by the Atlas Corporation on June 4, 1932, for the capital stock of Chain Store Stocks, Inc., stated (id., Commission's Exhibit No. 1970):

> The changes upward and downward in the value of the portfolios of the different companies affect the stock of such companies to different degrees because of differences in capital structures. Your Company, for example has only Common Stock outstanding, whereas Atlas Corporation has outstanding both Common and Preference stock. Therefore, in the event of increase in the value of portfolio holdings, the asset value of Atlas Corporation common stock because of the "leverage" provided for it by the outstanding Preference Stock will increase comparatively more rapidly than increase in the value of such portfolio * * *.
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> * * * * * * *
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> Each holder will have to study the merits of the exchange from his own particular standpoint. For example, in the case of your Company, you would be exchanging a stock having an asset value substantially in excess of its present market value but having a comparatively narrow market and having no so-called "leverage" (because there are no senior securities outstanding) for a stock which has a broader market and has a substantial "leverage" because of its Preference Stock * * *. An analysis of the market prices of the stock of various investment trusts will disclose that this element of "leverage" is commanding a substantial premium.

values. To the preferred stockholders of such companies the acquiring corporation stressed the fact that their shares had no "leverage." [114]

Solicitors and salesmen also emphasized the leverage advantage of Atlas Corporation's common stock in the event of a rise in market prices without mentioning the concomitant accentuated decline in the asset value of such common stock in the event of a fall in the market. Thus, a letter dated November 29, 1932, from a Hemphill, Noyes & Co. salesman to a stockholder of Securities Allied Corporation stated: [115]

It seems to me that it is very much to Mr. * * * advantage to hold the Atlas stock due to its senior capitalization, which gives it a leverage of 2½ to 1 over the general run-of-market securities, which includes Securities Allied. The leverage may be best pictured as follows:

$30, 000, 000	Value of Atlas preferred.
21, 000, 000	3,000,000 shares of Atlas common, at $7.00.
$51, 000, 000	
$51, 000, 000	Market appreciation—100%.
$102, 000, 000	Total—value of Atlas Corporation after 100% market rise.
—$30, 000, 000	Value of Atlas preferred.
$72, 000, 000	Balance left for 3,000,000 shares of common stock, or $24.00 per share.

[114] For example, the June 4, 1932, offers of exchange made by Atlas Corporation to the preferred and common stockholders of Federated Capital Corporation stated (ibid.):

Your Company, for example, has outstanding Preferred Stock and Common Stock. The Preferred Stock has on the date hereof an indicated asset value of * * * approximately $15.75 per share and the Common Stock has no asset value. The asset value of such Preferred Stock will increase substantially in direct proportion to any increase in the value of the assets of your Company until the full value of $25 per share plus the dividends accrued thereon is reached. It will require approximately a 60% increase in the value of the assets of your Company before the Common Stock of your company has any asset value. Thereafter the Common Stock will increase in asset value comparatively more rapidly than increase in the assets of your Company. Atlas Corporation has outstanding both common and preference stock and the Common Stock has asset value. Therefore, in the event of increase in the value of the portfolio holdings, the asset value of Atlas Corporation Common Stock will increase comparatively more rapidly than increase in the value of such portfolio. The option warrants to purchase Common Stock of Atlas Corporation have usually increased or decreased in market value in a rather uniform relationship to the increase or decrease in market value of the common stock of Atlas Corporation purchasable thereunder.

* * * * * * *

Each holder will have to study the merits of the exchange from his own particular standpoint. For example, in the case of your Company: (1) the holders of Preferred Stock would be exchanging a stock having an asset value * * * substantially in excess of its present market value, but having a comparatively narrow market and having no so-called "leverage" (because there are no securities senior to it outstanding) (a) in part for a preference stock * * * and (b) in part for a Common Stock which has a substantial "leverage" and which in the normal course should respond quickly to any improvement in market values of securities generally * * * (2) the holders of Common Stock would be exchanging a stock that will have no asset value until market prices for securities improve materially for an option warrant which should increase in market value in a rather uniform relationship to any increase in market value of the common stock of Atlas Corporation.

The Equity Corporation in some cases in its solicitation literature pointed out the disadvantage of "leverage" in a period of declining market values for securities. Thus, in an exchange offer made to the preferred and common stockholders of Interstate Equities Corporation on June 8, 1933, it was stated (op. cit. supra, note 79, Commission's Exhibit No. 839):

The common stock of The Equity Corporation * * * is what is generally known as a "leverage type" common stock. Experience has shown that after senior securities are fully covered by assets, the asset value of a leverage type stock rises at a more rapid rate than the market value of the underlying portfolio and, conversely, the asset value of such a stock will decline at a more rapid rate than the depreciation of the value of the underlying portfolio.

[115] Op. cit. supra, note 2, Commission's Exhibit No 2037, Item 1.

You will see by the above figures that if the general market went up 100%, Atlas common would go from $7.00 to $24 due to the $30,000,000 of preferred stock which creates this leverage, while the general market was only doubling and Securities Allied doubling from its present bid of 6½ to 13.

Applying the method used by this salesman, it is clear that a 50% decline in the value of the assets of Atlas Corporation would result in the eradication of any asset value for the common stock of Atlas Corporation. In the same situation the value of the Securities Allied Corporation common stock, a nonleverage security, would decline only 50%. The converse of the example given by the salesman was, however, not pointed out in his letter.

Similarly, on May 16, 1930, Atlas Corporation made an exchange offer for the stock of All America General Corporation. A majority of the directors of All America General Corporation caused to be issued a circular letter to the corporation's security holders expressing disapproval of the offer because of the substantial disparity in favor of Atlas Corporation between the asset value of All America General Corporation's stock and the Atlas Corporation stock offered therefor. In opposition to these letters issued by a majority of the directors of All America General Corporation, C. Shelby Carter, Harold C. Richard, John W. Campbell, and Clarence H. Nichols, directors of All America General Corporation who were being secretly compensated by Atlas Corporation for their efforts in inducing exchanges, prepared a circular letter which was shown to Mr. Odlum, the president of Atlas Corporation,[116] and which was to be sent to the stockholders of All America General Corporation. This letter, which was dated May 31, 1930, stated in part:[117]

On account of the limited dividend and the limited rights in liquidation of the $3 preference stock, a 25% increase in the net assets of Atlas Corporation results in a 40% increase in the net assets applicable to the Common Stock. This leverage does not exist in the case of All America General Corporation.

No mention was made of the aggravated decline in asset value of the common stock of Atlas Corporation which would be induced by "leverage" if the assets of Atlas Corporation declined in value.

Mr. Richard, one of the directors of All America General Corporation, whose name appeared as one of the signers of the letter,[118] conceded that the letter should have mentioned the downward effect of leverage on the asset value of the common stock of Atlas Corporation. He testified as follows:[119]

Q. Another statement in the letter is: "on account of the limited dividends and limited rights in liquidation of the $3 preference stock" that is of the Atlas Corporation, "a 25% increase in the net assets of the Atlas Corporation results in a 40% increase in the net assets applicable to the common stock, and this leverage does not exist in the case of All America General Corporation," the argument being that a person giving his All America General Corporation stock and getting common stock gets into a leverage situation and with an increase of 25% in the assets of Atlas Utilities Corporation, there is an

[116] Id., at 17763.
[117] Public Examination, All America General Corporation, Commission's Exhibit No. 1641.
[118] Ibid., and see supra, pp. 1332–3.
[119] Op. cit. supra, note 117, at 15745–6.

increase in the net assets of the common stock of Atlas of 40 percent, but I notice that there is no statement that with a decrease of 25 percent of the (total) asset value of Atlas Corporation, there is a resultant decrease of a greater percent in the net assets of the common stock.

A. Absolutely.

Q. Isn't that true?

A. Yes, sir.

Q. Don't you think that that should have been said in this memorandum when stockholders were * * * being persuaded to turn in their common stock in a nonleverage situation, for the common stock of a leverage situation * * *?

A. I certainly think it should.

The failure to disclose the disadvantages of "leverage" was particularly significant in those cases where alternative offers of either preferred or common stock were made for the shares of controlled investment companies. For example, Atlas Corporation did not desire because of the "handicap of leverage" to increase its preferred stock capitalization. Especially would this be so where its preference stock offer, if accepted, would result in a loss in assets to Atlas Corporation.

The exchange offer made by Atlas Corporation for the stock of Exide Securities Corporation illustrates the efficiency, in such a situation, of statements emphasizing only the advantageous side of the "leverage" in the Atlas Corporation common stock. On July 16, 1930, Atlas Corporation made an offer to exchange for each share of the capital stock of Exide Securities Corporation,[120] a nonleverage investment company, either nine-twentieths of a share of its preference stock or two and one-fourth shares of its common stock. Atlas Corporation had previously secured the approval of its offer by the directors of Exide Securities Corporation. The asset value of the stock of Exide Securities Corporation at the date of the offer was approximately $20 per share; its market value was $16.38. The asset value of the two and one-fourth shares of the common stock of Atlas Corporation offered for the Exide Securities Corporation stock was then $13.73 per share, although the two and one-fourth shares of such stock had a market value of $23.50. In other words, Exide Securities Corporation stockholders who accepted the offer would lose in asset value $6.27 per share of their stock, but would, however, acquire securities whose market value exceeded the asset value of their stock. On the other hand, the Atlas Corporation preference stock was more favorable in terms of asset values to Exide Securities Corporation stockholders. The liquidating value of nine-twentieths of a share of Atlas Corporation preference stock was $22.50 and its market value was approximately $15.75.[121] Thus, an Exide Securities Corporation stockholder accepting the Atlas Corporation preference stock therefore actually gained $2.50 in assets, though he suffered a slight sacrifice in market values. In addition, the Exide Securities Corporation stockholder would receive a security more analogous to his own in that the preference stock, though it had an upper limitation in asset value, was not subject to the fluctuations in value induced by leverage.

The directors of Exide Securities Corporation recommended acceptance of the Atlas Corporation offers, but did not attempt to advise

[120] Op. cit. supra, note 2, Commission's Exhibit No. 1970.

[121] Id., Commission's Exhibit No. 2001 (pp. 35–37).

their stockholders as to which of the alternative offers to accept. Obviously, Atlas Corporation would desire the acceptance of its common stock offers. Acceptance of the preference stock offers would result in a substantial loss in assets to Atlas Corporation and would also increase the leverage disadvantage of its common stock by adding additional preference stock to its capital structure. In fact, the offering letter of Atlas Corporation stressed the market value and the marketability of the Atlas Corporation common stock. It did not refer to the asset value of either the Exide Securities Corporation or the Atlas Corporation common stock. The only comment the letter made on the balance sheet of Atlas Corporation which accompanied its offering letter was that such balance sheet indicated that "a very substantial amount of assets is behind each share of $3 Preference stock * * *." The letter then went on to emphasize the market value and the leverage of the Atlas Corporation common stock:[122]

> Thus each holder of one share of Exide Securities Corporation capital stock accepting this offer and expecting to receive common stock of Atlas Corporation will receive on account thereof 2¼ shares of common stock of Atlas Corporation, having an aggregate market value of approximately $23.50.
>
> It is significant to note that on account of the limited dividend and the limited rights in liquidation of the $3 Preference stock * * * of Atlas Corporation, an increase in its assets results in a greater increase in the net assets applicable to its Common Stock than would be the case of a corporation having no preferred stock or other senior securities outstanding. This leverage does not exist in the case of Exide Securities Corporation, having, as it does, only one class of stock.

As a result of this offer, Atlas Corporation acquired a total of 232,583 shares of the capital stock of Exide Securities Corporation, or approximately 80% of the 288,297 shares of Exide Securities Corporation then outstanding. Of the total Exide Securities Corporation stock acquired by Atlas Corporation under this offer, only 41,638 shares were exchanged for Atlas Corporation preference stock. As a result of the exchange Atlas Corporation derived an increase in asset values on the basis of the disparities in the asset values as at the date of the offer of the shares involved in its common stock offer of $1,091,337.[123]

b. Asset Value of Acquiring Corporation's Common Stock

Since the assets of investment companies normally consist of readily marketable securities, the asset values of their own security issues more nearly represented the actual value of these securities than did market values which may have been affected by artificial factors, such as manipulative or stabilization accounts, or other factors which were to a substantial extent determinative of the market price of investment company equity securities in the period 1927 to 1934.[124] To the investor not concerned with the immediate salability of his investment company security, asset value represents the actual value of his interest in his company; it constitutes the value of his property interest in the

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[122] Id., Commission's Exhibit No. 1970.

[123] Ibid.

[124] For a discussion of the factors which influence the asset value and market prices of investment company securities see Part Two (House Doc. No. 70, 76th Cong.), Ch. IV, pp. 273–328 and Part Three (House Doc. No. 279, 76th Cong.), Ch. III, pp 956–76.

company, were it to be immediately dissolved.[125] Consequently a knowledge of the asset value of investment company securities offered in exchange for his own securities in such companies is clearly of importance to the investor.

The essential purpose of the exchange programs of investment companies was to gain in assets as a result of the exchanges of securities. The terms of most of its exchange offers were fixed to result in gains to the acquiring corporation represented by the difference between the asset value of the exchanged investment company security and the asset values of the acquiring corporation's securities exchanged. Nevertheless, the solicitation literature rarely referred to the asset values of the securities which were the subject of the offers. In many instances, however, a copy of the balance sheet of the acquiring corporation accompanied the exchange offer from which the asset value of its common stock could be computed by an investor possessing a knowledge of corporate finance and accounting.[126] While the early offers of Atlas Corporation did not specifically disclose the asset value of its common stock but did include balance sheets, the June 4, 1932 offers of Atlas Corporation included a "combined" statement of financial condition of Atlas Corporation and its then subsidiaries from which the then actual asset value of Atlas Corporation's common stock would have been difficult to compute.[127]

(1) MISLEADING REPRESENTATION AS TO METHOD OF CALCULATING ASSET VALUES

As has been pointed out, little organized and influential opposition to the exchange programs existed. Most of the managements of the companies acquired either aided the acquiring corporation in its program or did not oppose it. However, as has already been described,[128] Atlas Corporation encountered opposition from the majority of the board of directors of All America General Corporation in its original exchange offer made to the stockholders of that investment company on May 16, 1930. The Atlas Corporation offer made on May 16, 1930, was to exchange two shares of its common stock having a market value of $27 for one share of All America General Corporation capital stock having a market value of $21.50. In terms of market values the offer was beneficial to All America General Corporation stockholders and the offer stressed this fact. Not disclosed, however, in the Atlas Corporation offering letter was the fact that its common stock offered in the exchange had an asset value of $17.70 and the All America General Corporation stock an asset value of $26 per share.

On May 20, 1930, Mason B. Starring, Jr., the president of All America General Corporation, sent a circular letter to the company's stockholders advising them that a majority of the company's directors were unwilling to recommend the exchange offer. The letter further stated that, on the basis of the exchange offer, stockholders agreeing to the exchange "will receive two shares of the Atlas Common

[125] This statement is, of course, subject to the limitation that the market could absorb the blocks of portfolio securities without any substantial effect on the market price due to the increase of such securities offered for sale.

[126] Op. cit. supra, note 2, Commission's Exhibit No. 1970.

[127] This type of balance sheet will be discussed infra.

[128] See *All America General Corporation,* supra, pp. 1324–37.

Stock, having an aggregate liquidating value of approximately $17.70 in exchange for one share of this Company having an aggregate liquidating value of $26 per share. It is unnecessary to point out that this would be a material sacrifice of book value, amounting to an approximate aggregation of all shares of your company outstanding of $1,370,000."

On May 22, 1930, Mr. Starring again wrote a circular letter [129] to the stockholders of his corporation informing them that on May 21, 1930, a majority of the board of directors of the corporation had voted to reject the Atlas Corporation offer because of the loss in asset value which would be suffered by All America General Corporation stockholders who accepted the offer. The letter also stated that "in view of the excellent condition of your company, [the directors] could see no reason for considering a merger with any other trust."

To combat the argument of the majority of the directors of All America General Corporation, that the offer was inequitable from the standpoint of asset values, Mr. Carter, one of the directors retained for a monetary consideration to aid Atlas Corporation in soliciting exchanges,[130] prepared a letter to be sent to the stockholders of All America General Corporation.[131] This circular letter,[132] which was sent to the stockholders by Mr. Carter on May 31, 1930, was shown to Mr. Odlum [133] and signed by Messrs. Richard, Nichols, and Campbell, other directors of All America General Corporation who were also receiving a consideration for their aid to Atlas Corporation. The fact that Messrs. Nichols, Campbell, and Richard were being compensated by Atlas Corporation for their services in advocating the exchange offer was not mentioned in the letter.[134]

The letter sent to the stockholders of All America General Corporation by Mr. Carter pointed out the advantage of the Atlas Corporation offer, on the basis of the market values of the securities to be exchanged, to All America General Corporation stockholders and then made several arguments designed to minimize the importance of the asset losses which would be suffered by exchanging stockholders. This letter stated: [135]

In a letter of May 20, 1930, sent to stockholders of All American General Corporation, it was stated that the exchange "would be a material sacrifice of book values amounting to an approximate aggregate of $1,370,000." This figure is incorrect because it fails to take into consideration that the holder of All America General Corporation Common Stock who makes the exchange will, through the Atlas Corporation shares he receives, participate pro rata in any increase of liquidating value accruing to Atlas Corporation common stock by reason of the exchange.

If all holders of Capital Stock of All America General Corporation should make the exchange the liquidating value of the Common Stock of Atlas * * * Corporation would be between $9.50 and $10.00 per share * * *.

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[129] Op. cit. supra, note 117, Commission's Exhibit No. 1639.

[130] See *All America General Corporation,* supra, pp. 1324–37.

[131] Op. cit. supra, note 117, at 15803.

[132] Id., Commission's Exhibit No. 1641.

[133] Op. cit. supra, note 2, at 17763–4.

[134] Op. cit. supra, note 117, Commission's Exhibit No. 1641.

[135] Ibid.

That is the asset value of the two shares of Common Stock of Atlas * * * Corporation to be exchanged for each share of the Capital Stock of All America General Corporation would, on this basis, be between \$19.00 and \$20.00 instead of \$17.70, as stated in said letter of May 20th.

The sum total of this argument was simply that by becoming an Atlas Corporation stockholder, the asset loss to All America General Corporation stockholders would be about \$6.30 per share rather than \$8.30.

The letter also took the position that in calculating the liquidating value of Atlas Corporation's common stock it was "proper and logical,"[136] since no dissolution of Atlas Corporation was contemplated, to deduct the preference stock of Atlas Corporation from the net worth of the company not at the value to which it was entitled on dissolution (\$50.00 per share) but at its market value which was then substantially less than the amount to which such stock would be entitled on dissolution. The letter went on to state that "the difference between the market value of such preference stock and its preferential rights in liquidation is substantially in excess of \$1,000,000 which automatically increased proportionately the value of the common stock. However, none of this amount had been added to the asset value of the common stock in arriving at the liquidating value thereof stated above."

According to sound accounting principles and financial practice, asset values of equity securities are calculated by first deducting from the corporation's net worth all senior securities at the value which they are entitled to receive in any dissolution of the corporation. Mr. Odlum, when examined on the method of calculating the asset value of Atlas Corporation's common stock advocated in the letter sent to All America General Corporation stockholders, testified:[137]

A. * * * It may be that some of the arguments [contained in the above letter] are a little strained.

Q. Or tenuous?

A. A little tenuous, but still the same argument has been used many times and has been used by myself, even in appraisal of securities, in the last six years.

Mr. Richard, one of the All America General Corporation directors who aided Atlas Corporation, and one of the signers of the letter to the corporation's stockholders which has been quoted above, when examined on the method of calculating the asset value of the Atlas Corporation common stock described in the circular, testified:[138]

Q. Now, what does asset value of stock mean, Mr. Richard, to you?

A. You said the market value of the preferred—no, no, no—the par value (i. e., the dissolution value) * * *. That is what you have to figure when you figure that.

Q. Because * * * preferred stockholders are entitled to that, before the common stockholders can come in?

A. Yes, sir.

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[136] Ibid.

[137] Op. cit. supra, note 2, at 17764.

[138] Op. cit. supra, note 117, at 15744–5.

Q. And with respect to this statement, that it seems proper and logical to make a deduction only to the extent of the market value of the preference stock, you don't subscribe to that, do you?

A. Not unless you are figuring nothing but markets at the time, and if you are figuring nothing but market values then naturally you have got to figure the both sides, but if you are figuring liquidating value then you have got to figure it the other way.

Q. It says "furthermore in arriving at this liquidating value" * * * so that they are talking about liquidating values.

A. Yes.

Q. The difference between the market value of such preference stock and the preferential rights in liquidation is substantially in excess of $1,000,000 which automatically increased proportionately the value of this common stock. Do you agree that it was even fair to make that argument to the stockholder—to say that really the liquidating value of that stock is not the par value of the preference stock but merely its market value?

A. I should think that the practice of public accountants would probably tell me more about it—I don't know. It is a technical question and you look at it one way or the other—personally if I was to go and try to argue with someone on it, I would take your way of looking at it.

As the result of its offers of May 16, 1930, and the circulars sent to All America General Corporation by those of its directors who were aiding Atlas Corporation, the latter corporation acquired 84,727 shares of the capital stock of All America General Corporation or in excess of 50% of the 165,600 shares of All America General Corporation then outstanding.[139] Stockholders of All America General Corporation who accepted these exchanges suffered an aggregate loss in asset value of approximately $470,000.[140]

(2) USE OF "COMBINED" FINANCIAL STATEMENTS

As has been indicated, the intention of the acquiring corporations was to acquire, if possible, by the ultimate processes of dissolution, merger, or consolidation, the entire ownership of the assets of their controlled investment companies by means of future offers to exchange the acquiring corporations' own securities for the public's holdings of the securities of their controlled investment companies, or by the purchase of such securities.

This purpose added greater importance to the character of the financial statements which the acquiring corporations released to the public. Their financial statements would presumably be consulted by investors with reference to their exchange offers. Such financial statements, in order to be complete, would have to indicate clearly the extent of the minority interests in the controlled investment companies, as well as the asset value of the common stock of the acquiring corporations. Nevertheless, the financial statements released by the acquiring corporations did not indicate clearly either of these facts.

By December 31, 1931, Atlas Corporation was in control of 10 investment companies [141] other than Atlas Utilities & Investors Co., Ltd.,

[139] Op. cit. supra, note 2, Commission's Exhibit No. 2001 (pp. 20–22).

[140] Ibid.

[141] Id., Commission's Exhibit No. 1943. The controlled companies were: All America General Corporation; Allied Atlas Corporation (formerly known as Exide Securities Corporation); Aviation Securities Corporation; Chain Store Stocks, Inc.; General Empire

its Canadian predecessor. In several cases its control was based on the ownership of the common stock of leverage companies.[142] Such common stock in each case had no asset value. In other words, the preferred stockholders of such companies would have been entitled to receive all of the assets of such companies in the event of their dissolution. Atlas Corporation, at the end of 1931, held only a minority interest in the preferred stocks of the leverage investment companies which it controlled. In one case, that of Federated Capital Corporation, Atlas Corporation held a minority of the voting stock of all classes, its control having been maintained by means of a management contract.[143] And in another case, that of Securities Allied Corporation, Atlas Corporation controlled all of the 100,000 shares of voting common stock [144] but only 36% of the nonvoting common stock, which was, on dissolution entitled to an equal participation in the corporate assets with the voting stock.[145] Table 19 indicates the security holdings as of December 31, 1931, both of Atlas Corporation (and its subsidiaries) and of the public in the securities of the Atlas Corporation controlled companies.

Corporation; National Securities Investment Company; Securities Allied Corporation; Sterling Securities Corporation; Ungerleider Financial Corporation; and Federated Capital Corporation (ibid.).

[142] The leverage companies controlled were: National Securities Investment Company, Sterling Securities Corporation, and Federated Capital Corporation.

[143] See *Federated Capital Corporation,* supra, pp. 1278–93.

[144] Op. cit. supra, note 2, Commission's Exhibit No. 2001 (p. 113), and reply to the Commission's questionnaire for Securities Allied Corporation, Pt. II.

[145] See *Chatham Phenix Allied Corporation,* supra, pp. 1142–57.

TABLE 19.—*Security holdings in investment companies in the Atlas Corporation group by companies in the Atlas group and by the public, Dec. 31, 1931*

Name of company	Class of stock	Stock outstanding	Held by Atlas group		Held by outside public		
			Percent	Shares	Percent	Shares	Asset value
All America General Corp	$20 par common	165,600 shs	68.42	113,307 shs	31.58	52,293 shs	$758,633.47
All America General Corp	Option warrants	67,000 wrts	80.92	54,214 wrts	19.08	12,786 wrts	
Allied Atlas Corp. (Exide Securities Corporation).	No par common	288,220¾ shs	92.47	266,518 shs	7.53	21,702¾ shs	322,860.45
Atlas Utilities & Investors Co., Ltd	6% pref. ($100)	1,910 shs			100.00	1,910 shs	191,000.00
Atlas Utilities & Investors Co., Ltd	No par common	159,444 shs	100.00	159,444 shs			
Atlas Utilities & Investors Co., Ltd	Option warrants	55,697 wrts	3.48	1,940 wrts	96.52	53,757 wrts	
Aviation Securities Corp	No par common	134,000 shs	50.43	67,571 shs	49.57	66,429 shs	850,404.09
Chain Store Stocks, Inc	No par common	253,700 shs	66.07	167,611½ shs	33.93	86,088½ shs	932,092.62
Chain Store Stocks, Inc	Warrants	101,500 wrts	98.50	100,000 wrts	1.50	1,500 wrts	
General Empire Corp	No par common	201,856 shs	74.06	149,488 shs	25.94	52,367 shs	887,780.94
General Empire Corp	Warrants	106,426 wrts	100.00	106,426 wrts			
National Securities Investment Co	6% cum. pfd. ($100)	138,957 shs	26.59	36,945 shs	73.41	102,012 shs	6,781,279.54
National Securities Investment Co	$1 par common	939,144½ shs	66.34	623,039 shs	33.66	316,105½ shs	
National Securities Investment Co	Option warrants to purchase	339,080 wrts	73.73	250,000 wrts	26.27	89,080½ wrts	
Securities Allied Corp.:							
Chatham Phenix	No par, nonvoting	1,466,022 shs.[a]	[a] 36.42	533,988 shs.[b]	[b] 63.58	932,034 shs	15,001,397.24
Allied Corp	No par voting	100,000 shs.[a]	[a] 100.00	100,000 shs.[b]	[b] 100.00		
Sterling Securities Corp	Conv. 1st pfd. ($50 par)	278,865 shs	15.57	43,430 shs	84.43	235,435 shs	10,121,676.20
Sterling Securities Corp	($1.20) no par preferred	500,000 shs	6.46	32,292 shs	93.54	467,708 shs	
Sterling Securities Corp	No par, "A" common	603,802½ shs	14.39	86,896 shs	85.61	516,906½ shs	
Sterling Securities Corp	No par "B" common	298,297 shs	70.64	210,708 shs	29.36	87,589 shs	
Ungerleider Financial Corp. (The Financial Corp.).	No par common	244,320 shs	82.02	200,384 shs	17.98	43,936 shs	1,538,108.32
Total							37,385,232.87

[a] 40.48 percent.

[b] 59.52 percent.

Source: Public Examination, Atlas Corporation, Commission's Exhibit No. 2001 and the annual reports of the controlled companies of Atlas Corporation as at Dec. 31, 1931, contained in Part I of the replies to the Commission's questionnaire for such companies.

The public "owned" approximately $37,385,000 of the assets of Atlas Corporation's controlled investment companies.[146] Since the net assets of Atlas Corporation and these controlled companies, after the elimination of all intercompany holdings, at December 31, 1931, approximated $53,700,000,[147] it is obvious that the assets of Atlas Corporation, including its interest in these companies, were only approximately 30% of the net assets of the entire group of companies; the bulk of the assets in the group was "owned" by the public holders of the securities of the subsidiary corporations.

The first financial statement issued by Atlas Corporation, as of December 31, 1931, was released on February 29, 1932,[148] captioned, "Combined Statement of Financial Condition."[149] This "combined statement" was certified by Lybrand, Ross Bros. & Montgomery, certified public accountants, as setting forth "the combined financial condition of the said companies." The "combined statement" indicated the assets of Atlas Corporation and its subsidiaries in much the same manner as would a consolidated statement. However, the liabilities side of the "combined" financial statement differed radically from that of a consolidated statement of financial condition in that the exact amount of the public's interest in the underlying corporations was not disclosed. The "combined" statement lumped together in one sum the total net worth of the group of companies, and no segregation was made on the balance sheet of the dollar amount applicable, on the one hand, to Atlas Corporation's stock, and on the other hand to the capital stocks of the subsidiary companies in the hands of the public.[150] The report did not contain any indication of the fact that the interest of Atlas Corporation in the net assets of the combined companies was equivalent, as has already been indicated, to only approximately 30% of the net assets. In sum, the combined statement conveyed substantially the same information as a consolidated statement would have with reference to the total assets of the group of companies, but differed from a consolidated statement in that it did not at all indicate the respective portion of the net assets applicable to the interest of the Atlas Corporation stock and to the stock of the controlled investment companies held by the public.[151]

No precedent can be found for the use of the term "combined balance sheets."[152] Rodney F. Starkey, of Price, Waterhouse & Co., testified[153] with reference to a similar balance sheet utilized by The

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[146] See Table 19, p. 1402.

[147] Op. cit. supra, note 2, Commission's Exhibit No. 1943.

[148] Id., Commission's Exhibit No. 1943.

[149] Ibid.

[150] Ibid. It is not to be inferred that a consolidated statement of financial condition would have been a proper one in the circumstances.

[151] It is to be noted that Atlas Corporation on December 31, 1932, when, as a result of its exchange offers of June 4, 1932, it had acquired a majority ownership interest in the assets of its subsidiaries, published a "Consolidated Statement of Financial Condition" of itself and of its subsidiaries which disclosed the ownership interest of minority stockholders of its subsidiaries. On December 31, 1932, the consolidated net assets of Atlas Corporation and its subsidiaries were $49,827,198 (id., Commission's Exhibit No. 1943). Of these assets the consolidated statement on its liabilities side disclosed that $35,421,778 was "applicable to capital stocks of Atlas Corporation" and $14,405,419 was "applicable to capital stocks of subsidiary companies in the hands of the public at December 31, 1932" (ibid.).

[152] Op. cit. supra, note 79, at 11974.

[153] Id., at 11966–7. 11972, 11975.

Equity Corporation in connection with its exchange offers [154] that he did not know what meaning might be conveyed to the investor by the phrase "combined balance sheet:"

Q. * * * Now, will you just elaborate a little for me upon what the functions of a consolidated balance sheet are supposed to be?

A. I would say generally that a consolidated balance sheet was intended to show the picture of an enterprise, as compared to the picture of an individual entity—as I say, where they are substantially wholly owned.

Q. Where they are substantially wholly owned—always subject to the uncompromising principle that it should not be misleading?

A. For the purpose for which it is used—right.

Q. I notice you qualify your statement by saying subsidiaries which are wholly owned. Why do you insist on those qualifications?

A. Well, simply to prevent abuses of treatment of minority interests, and that is a very vague and general statement. I could not elaborate on it without having specific instances.

Q. One of the difficulties with a consolidated balance sheet is that it may create a misleading impression, in this respect: You may get a picture of the assets of the corporation which is not genuine or true, because there may be a substantial minority interest which owns a substantial interest in the company; is not that so?

A. That is very possible.

* * * * * * *

Q. In the layman's mind, looking at the balance sheet, if he is shown the total assets with a specific figure that, of course, makes an impression on him, does it not?

A. Yes.

* * * * * * *

A. I think a consolidated balance sheet, in the mind of the average layman, has a very definite significance. I think when you depart from generally accepted practice, understanding and accounting, it is well to use a different term, rather than confuse people's minds.

* * * * * * *

Q. Now, you said that you would not sign a consolidated balance sheet under the circumstances which I enumerated to you, because the words "consolidated balance sheet" had definite connotations in the minds of the public; is that not so?

A. I do not recall exactly how I said, but that sounds like a reasonable statement.

Q. Are you familiar with what connotations or inferences are present in the investor's mind when he sees the words "combined balance sheet?"

A. I do not know.

The "combined statement," by not indicating the dollar value of Atlas Corporation's interest in the combined net assets, also foreclosed any possibility of ascertaining either the asset value of the Atlas Corporation common stock or the dollar amount of the public's interest in the net assets of the controlled investment companies except by an involved computation based in part on additional information not included in the combined statement. The combined statement included a schedule [155] indicating the number of outstanding

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[154] See infra, pp. 1408–10.

[155] Op. cit. supra, note 2, Commission's Exhibit No. 1943.

shares of Atlas Corporation and the number of the outstanding shares of its subsidiaries held by the public. The procedure open to an investor who wished to ascertain the dollar value of the public interest in the group assets and the asset value of the Atlas Corporation common stock, involved a measure of accounting and analytical skill. It would have been at least necessary to examine the balance sheets of each of the controlled companies (which were not included in the Atlas Corporation report) in order to ascertain the asset value per share of each class of stock of the respective companies. Then it would have been necessary to multiply the per share asset value by the number of shares of the company indicated in the schedule accompanying the "combined" statement as belonging to the public. The addition of the amounts so derived for each company would have indicated the dollar amount of the public's interest in the combined assets. This dollar sum if deducted from the net assets indicated in the "combined statement" for the combined group would result in the sum applicable to the capital stock of Atlas Corporation. If there then be deducted from this figure the outstanding shares of Atlas Corporation preference stock at their value on any dissolution of the company, the remaining sum would constitute the amount applicable to the Atlas Corporation common stock which, if divided by the number of Atlas Corporation common shares outstanding, would give the per share asset value of the Atlas Corporation common stock.

The Atlas Corporation report as of December 31, 1931, containing the "combined balance sheet," was used in connection with Atlas Corporation's exchange offers. It was included in the literature sent to the stockholders of its subsidiaries in connection with its June 4, 1932 offers of exchange.[156] These offers of exchange were made to the then existing 12 investment companies controlled by Atlas Corporation, that is, the 10 companies controlled as at December 31, 1931, and Atlantic Securities Corporation and American, British & Continental Corporation, control of which was acquired by Atlas Corporation in 1932.[157] Each offer to the stockholders of each company indicated that simultaneous offers were being made to the stockholders of all other Atlas Corporation controlled investment companies.[158]

Each of the June 4, 1932, offers also included a "Combined Statement of Financial Condition" of Atlas Corporation and its subsidiaries as of April 30, 1932, certified by Lybrand, Ross Bros. & Montgomery. This "combined statement," like the initial "combined statement" as at December 31, 1931, lumped together in one sum approximately $48,000,000 as the "total amount applicable to capital stock of combined companies outstanding in the hands of the public," including the capital stock of Atlas Corporation itself.[159] Neither the circular letter containing the exchange offer nor any footnote to the "combined statement" as of April 30, 1932, revealed or even indicated the dollar amount of the net assets of the combined group of companies applicable to the shares of the subsidiary companies held

[156] Id., Commission's Exhibit No. 1970.
[157] Id., Commission's Exhibits Nos. 1958. 2001.
[158] Id., Commission's Exhibit No. 1970.
[159] Ibid.

by the public. And the public, as at June 3, 1932, still owned the greater portion of the assets of the combined companies. The "combined statement" as at April 30, 1932, also failed to reveal the actual existing asset value of Atlas Corporation's common stock (which was the medium of exchange offered in most cases) although, as will be seen, the offering literature did indicate the asset value of the Atlas Corporation stock which would result if all the offers of exchange made on June 4, 1932, were accepted by stockholders of the controlled companies.

Unlike the "combined" statement of condition as at December 31, 1931, the "combined" statement as at April 30, 1932, was stated in the offering literature to be a *pro forma* statement;[160] that is, a statement which would indicate the financial position of Atlas Corporation upon the happening of a certain contingency. The contingency upon which the "combined" balance sheet was based, however, was stated only in the following sentence contained in the offering letters:[161]

> Using the combined statement of financial condition on page 2 as the base, but adjusting the item "Investments" to the market or bid prices of the securities as of the date of this offer, there is an individual asset value of approximately $7.30 per share for the approximately 3,900,000 shares of Common Stock of Atlas * * * Corporation, if all of the holders of capital stock outstanding at the date hereof of all the companies should accept the offer.

The "combined statement" therefore was intended to indicate the financial condition of Atlas Corporation if all of its exchange offers were accepted.

The $7.30 asset value for the Atlas Corporation common stock was a hypothetical figure. However, in the offering circulars sent to several of the nonleverage companies controlled by Atlas Corporation it might have been interpreted as an actual asset value. For example, the exchange offer[162] sent to the stockholders of Aviation Securities Corporation stated:

> * * * In the case of your Company (Aviation Securities Corporation) you would be exchanging a stock having an asset value substantially in excess of its present market value but having a comparatively narrow market and having no so-called "leverage" * * * for a stock (Atlas Corporation common stock) which has a broader market and has a substantial "leverage" because of its Preference Stock and which is quoted on the market at a lesser discount from asset value as indicated above.

The only asset value mentioned for the Atlas Corporation common stock in the offering circular was the hypothetical figure of $7.30 per share. Since the market price of Atlas Corporation common stock was then $5 per share,[163] the stock then was apparently selling at a discount from its hypothetical asset value stated in the offer. Actually, the asset value of the common stock of Atlas Corporation on June 4, 1932, based on its own assets and evaluating its holdings of

[160] Ibid.

[161] Ibid.

[162] Ibid. The statement appeared in the June 4, 1932, exchange offer circulars sent to the stockholders of Chain Store Stocks, Inc., Ungerleider Financial Corporation and Securities Allied Corporation (formerly known as Chatham Phenix Allied Corporation) (Ibid.)

[163] Id., Commission's Exhibits Nos. 1970, 2001.

the securities of its subsidiary investment companies at their ultimate asset value, was $2.97 per share.[164] The Atlas Corporation common stock therefore was selling on the market at a substantial premium over its existing asset value possibly due to some extent at least to the activity of Allied General Corporation in the market purchasing of such shares.

The cardinal assumption made in the preparation of the Atlas Corporation *pro forma* "combined" balance sheet was that all of the exchange offers would be accepted, a fact unlikely of attainment.[165] The exchange offers themselves stated "that it is not expected that all of the holders of shares of various companies will avail themselves of the offers and it is only desired that those shareholders do so who believe the exchange will be to their advantage."[166] Moreover, the *pro forma* combined balance sheet would not accurately reflect the condition of Atlas Corporation even if it obtained sufficient exchanges of its controlled companies' stock to effect their merger, consolidation, or liquidation. Upon a merger or consolidation, some stockholders would demand the right to receive in cash the appraised value of their shares; on any dissolution of the controlled companies minority stockholders would be entitled to receive the pro rata share of the corporate assets. Finally, as this Commission has said with reference to a similar combined balance sheet issued by The Equity Corporation, "the fact remains that the *pro forma* combined statement was predicated on the assumptions both that the exchange program would be completed within a reasonable time and that it would be accomplished on the basis of the ratios first proposed. In other words, it assumed completion of the exchange program within such period of time that any material change in the value of the assets or the amount of the liabilities of the companies would be unlikely."[167] However, Atlas Corporation continued until the middle of 1933 to make exchange offers for the stock of the companies included in its June 4, 1932 offer and in several cases the terms of the offers were changed.[168]

Mr. Odlum, although conceding these difficulties were involved in the use of the *pro forma* combined statement, asserted that the "combined balance sheet" was approved by the accounting firm of Lybrand, Ross Bros. & Montgomery and that the "combined balance sheet" was the only method of portraying to the stockholders of the Atlas Corporation's controlled investment companies its financial condition in the event of the success of its exchange program.[169]

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[164] Id., Commission's Exhibit No. 2001.

[165] Furthermore, the propriety of the use of a *pro forma* financial statement in this situation is open to question. As this Commission has said elsewhere (op. cit. supra, note 10, pp. 256–7):

> A *pro forma* balance sheet should be used only where the contingencies upon which it is based are reasonably certain to occur within a reasonably short period of time. It is evident that otherwise such a balance sheet is likely to create a definitely misleading picture. This is even more clearly the case where the contingencies upon which the balance sheet are based cannot occur.

[166] Op. cit. supra, note 2, Commission's Exhibit No. 1970.

[167] Op. cit. supra, note 10, p. 258.

[168] Op. cit. supra, note 2, Commission's Exhibits Nos. 1970, 2001.

[169] Derived from supplementary information supplied the Commission for Atlas Corporation.

However, the combined balance sheet indicated only the maximum range of possible advantage to the holders of the subsidiary investment company stocks who accepted the exchange offers. In addition to the combined balance sheet, no statement of the financial condition of Atlas Corporation itself, based on its own assets and evaluating its holdings of the securities of its subsidiaries at their ultimate asset value, was included in the offering literature. Such a statement would have revealed the then actual asset value of Atlas Corporation's common stock and would have indicated the dollar amounts of the assets in the combined statement then actually applicable to Atlas Corporation itself. The investor would then have before him the minimum as well as the maximum range of advantage in the acceptance of the Atlas Corporation's offer. He would be enabled, by a simple calculation, to determine the extent of the public's ownership interest in the combined assets, a fact of importance in attempting to gauge the probability of the eventual success of the exchange program. Obviously, the greater the proportion of the total assets owned by the public, the less likely would be the complete success of the exchange program. The investor could also ascertain, if a statement of the financial condition of Atlas Corporation alone had been included in the solicitation literature, that the complete success of the offers would more than double the asset value of the existing Atlas Corporation common shares,[170] whereas in many cases even on the basis of $7.30 as the asset value of the Atlas Corporation common stock, exchanging stockholders of the controlled companies would suffer losses in asset value.[171]

The Equity Corporation, in connection with its offers of exchange made in 1933 for the shares of its controlled investment companies, Yosemite Holding Corporation, Chain & General Equities, Inc., Inter-

[170] As has been stated, the asset value of the common stock of Atlas Corporation as at June 4, 1932, was $2.97 a share. On the assumed complete acceptance of its exchange offers, the asset value of such common stock would have been $7.30 a share.

[171] For example, on June 4, 1932, the asset value for each share of the stock of Chain Store Stocks, Inc., was $7.60 a share (op. cit. supra, note 2, Commission's Exhibit No. 1970). In exchange for each share of Chain Store Stocks, Inc., Atlas Corporation offered four-fifths of a share of its common stock (ibid.). On the basis of an asset value of $7.30 for a full share of Atlas Corporation's common stock, the four-fifths of a share offered for each share of the stock of Chain Store Stocks, Inc., would have an asset value of $5.84, as against an asset value of $7.60 for each share of Chain Store Stocks, Inc. Moreover, the asset value of $7.60 per share of the stock of Chain Store Stocks, Inc., was based on the market value of its portfolio securities and as the exchange offer circular stated: "If the holdings of your company (Chain Store Stocks, Inc.) in affiliated investment trusts are appraised at their asset value rather than at market value, this figure (the per share asset value of Chain Store Stocks, Inc.) would be considerably increased."

Similarly, 3½ shares of the common stock of Atlas Corporation, which on the basis of an asset value of $7.30 per share had an aggregate asset value of $25.55, were offered for each share of the stock of Ungerleider Financial Corporation which had an asset value of $28.75 a share (id., Commission's Exhibit No. 1970). For the preferred stock of Federated Capital Corporation, having an asset value of $15.75 (ibid.), Atlas Corporation offered one-sixth of a share of its preference stock having a preference on liquidation of $50 a share for a full share of such stock, one-half share of its common stock having an asset value of $3.65 on the assumption that the full share had an asset value of $7.30, and a warrant to purchase three-fourths of a share of Atlas Corporation common stock (ibid.). The total asset value of this unit of securities was $11.98 based on the assumption that Atlas Corporation's common stock had an asset value of $7.30 a share. As has been stated, the asset value of Federated Capital Corporation's preferred stock was $15.75 a share.

state Equities Corporation, and Allied General Corporation, also made use of "Combined Statements of Assets and Liabilities." [172]

Several of the *pro forma* "Combined Statements of Assets and Liabilities" [173] of The Equity Corporation and its controlled companies, Allied General Corporation, Yosemite Holding Corporation, Chain & General Equities, Inc., and Interstate Equities Corporation, were certified by Price, Waterhouse & Company.[174] These combined statements did not reveal clearly that, of the combined assets of approximately $5,500,000 owned by all of the companies including The Equity Corporation itself,[175] only $300,000 of such assets were allocable to the securities of The Equity Corporation [176] and the remainder of such assets were applicable to public investors who held the preferred stocks of the companies controlled by The Equity Corporation.[177] In a footnote to several of the combined statements, however, it was stated that substantially the entire assets of the combined companies were applicable to the stock of the subsidiary companies held by the public.[178] Moreover, these combined statements were prepared by Price, Waterhouse & Company notwithstanding the fact that the accounting firm had refused to prepare a consolidated statement of financial condition for The Equity Corporation and its controlled companies on the ground that "in view of the outstanding capital stock held by outsiders we are of the opinion that the preparation of a consolidated balance sheet of The Equity Corporation and the * * * four companies is not in accordance with good accounting practice." [179] And although the "combined statements" were indicated to be pro forma statements of the financial condition of The Equity Corporation if all of its exchange offers were accepted, both Rodney F. Starkey of Price, Waterhouse & Company and W. F. Best, the treasurer of The Equity Corporation, conceded that it was highly improbable that all of the exchange offers would be accepted by the stockholders of the subsidiaries of The Equity Corporation.[180] Furthermore, Mr. Starkey conceded that the terms of the exchange offers would probably be changed from time to time with a consequent alteration in the number of shares of stock of The Equity Corporation which would have to be issued in such exchanges.[181] In other words, since the ultimate scope of The Equity Corporation's exchange program and the details of its execution differed materially from those assumed in the preparation of the "combined statements," such statements would not reflect even approximately the condition of The Equity Corporation at the conclusion of the exchange program.

The Equity Corporation also included in its exchange offer circulars a "Statement of Combined Portfolio" [182] of itself and its subsidiaries which suggested that The Equity Corporation itself possessed a large, well diversified portfolio. In fact, The Equity Corporation's assets at

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[172] See op. cit. supra, note 10, pp. 253–62.
[173] Op. cit. supra, note 79, Commission's Exhibit No. 1174.
[174] Id., Commission's Exhibits Nos. 1173, 1174.
[175] Ibid.
[176] Id., at 11986–9.
[177] Id., at 11997.
[178] Id., at 12001.
[179] Id., Commission's Exhibit No. 1175.
[180] Id., at 12014–5, 12030, 12045.
[181] Id., at 12023–4.
[182] Id., Commission's Exhibit No. 1173.

the inception of its exchange program consisted only of its holdings of 67% of the preferred, 70% of the Class A, and 72% of the common stock of Allied General Corporation and 61% of the common and 17% of the preferred stocks of Yosemite Holding Corporation.[183] The securities listed in the "Combined Statement of Portfolio" belonged almost exclusively to Interstate Equities Corporation, the negative asset value common stock of which was held by another subsidiary of The Equity Corporation.[184] The preferred stock of Interstate Equities Corporation which was 95% owned by the public [185] would have been entitled to all of the company's assets if it had been dissolved at the date that the "Combined Statement of Portfolio" was included in the exchange offer solicitation literature.[186] Nevertheless, officials of The Equity Corporation, in answer to inquiries of stockholders of its subsidiaries, stated that "The Equity Corporation being a much larger corporation, its diversification of investments should work out to the advantage of the holders of the stock * * *."[187]

V. DISSOLUTION, MERGER, CONSOLIDATION, AND SALE OF ENTIRE ASSETS OF INVESTMENT COMPANIES

A. Introduction

The merger, consolidation, or sale of the entire assets of investment companies constitute the usual procedures for the absorption of the assets of such companies by other investment companies. An investment company which has acquired a sufficient amount of the stock of another to effect its formal dissolution under applicable law, is enabled by these methods to absorb its proportion of the assets of the dissolved company. Although these procedures (mergers, consolidations, and dissolutions) are alike in that they accomplish the absorption by one company of the assets of another, they differ in important details which may seriously affect the rights of the stockholders of the companies involved.

A "merger" is defined as the absorption of one or more corporations by an existing corporation which survives, the other constituent corporations being extinguished. On the other hand, "consolidation" involves the union of two or more corporations to form a new corporation, all of the constituent companies being extinguished in the process.[1] In both cases, one corporation emerges which owns all of the assets of the former companies. A similar result may be obtained by the sale of all the assets of one company to another either for cash or the securities of the purchasing corporation. In this situation, however, the existence of the selling corporation is not *per se* terminated by the sale. Usually, however, particularly where the consideration for the sale has been the securities of the purchasing corporation,

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[183] Id., at 10710–2 and Commission's Exhibit No. 1175.

[184] Id., at 11989–91.

[185] Id., Commission's Exhibit No. 1175.

[186] Id., at 11989–91.

[187] Id., at 10710–12 and Commission's Exhibit No. 1035.

[1] 15 Fletcher, *Cyclopedia Corporations,* 1932, § 7041; Ballantine, *Manual of Corporation Law and Practice,* 1930, § 240; *Lee v. Atlantic Coast Line R. R. Co.,* 150 Fed. 775, 787 (C. C. S. C. 1906).

formal dissolution proceedings are thereafter taken to dissolve the selling corporation.[2]

The ultimate result of all of these procedures is the concentration of the assets of one or more formerly independent companies in one of the old companies or in a new company. Securities of the successor company are issued for the securities of the old companies. In the achievement of this result, a nonjudicial reorganization of the rights, privileges, and financial position of the stockholders of the various companies is accomplished.

1. ABSENCE OF REQUIREMENTS OF FULL DISCLOSURE OF PLANS

These voluntary reorganizations are at present to a substantial extent unregulated and unsupervised by any judicial or administrative agency. The registration and prospectus provisions of the Securities Act of 1933 ordinarily are not applicable to mergers, consolidations, or sales of assets effected pursuant to the provisions of the typical state statutes.[3] Section 14 of the Securities Exchange Act of 1934 empowers the Commission to make rules and regulations for the solicitation by the use of the mails or the facilities of interstate commerce of proxies, consents, and authorizations in connection with dissolutions, mergers, consolidations, and sales of all the assets of corporations only in the case of securities listed on national securities exchanges.

However, a great number of investment companies have no securities listed on national securities exchanges. At the end of 1936 only 103 investment companies of all types had one or more of their securities listed on an exchange. These companies possessed total assets valued at market at approximately $2,696,000,000. On the other hand, 388 investment companies of all types owning assets valued at $1,769,000,000 had none of their security issues listed on national securities exchanges. At the same year-end 99 management investment companies with total assets of approximately $2,636,000,000 had one or more security issues listed on securities exchanges. In contrast, 305 of such companies controlling assets of approximately $1,646,000,000, had none of their securities admitted to trading on any stock exchange.[4] Thus, investors in investment companies owning a substantial amount of the total assets of the investment company industry may be without the complete protection of either the Securities Act of 1933 or the Securities Exchange Act of 1934 in connection with the merger, consolidation, or sale of the assets of their companies. Nor do state statutes in general make any provision for the supervision of the solicitation material used to procure stockholder consents to mergers, consolidations, and sales of entire corporate assets.[5]

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[2] See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), Part VII, pp. 557, 579, et seq.

[3] See note 5 to the Commission's "Rules as to the Use of Form E–1 under the Securities Act of 1933 for Securities in Reorganization."

[4] See Part Two (House Doc. 70, 76th Cong.), Ch. IV, Table 84, p. 280.

[5] Many state securities acts exempt from their provisions securities issued in connection with mergers, consolidations, and sales of the corporate assets. (See, e. g., Ala. Rev. Code § 9880; Fla. Laws (1931 c. 14899 § 5; Hawaii Rev. Laws (1935) § 7335; Idaho

2. SCOPE OF STATE REGULATION OF MERGERS, CONSOLIDATIONS, AND SALES OF ASSETS

The provisions of the general incorporation laws of the various states,[6] under which investment companies and all other types of corporation, other than banks, insurance companies, public utility companies, railroads, etc., are generally created, usually prescribe the procedure for the legal effectuation of a dissolution, merger, consolidation, or sale of the corporate assets. Although the various state statutes differ in details vital to investors, such as the percentage of voting securities required to sanction mergers, consolidations, and sales of assets, the power of normally nonvoting security holders to vote on the question of the absorption of their assets by another company, and the privilege of dissenting security holders to receive an appraised value of their securities,[7] these state statutes present a fairly uniform procedure. In general, the various state laws vest the corporate directors with the power, in the first instance, to determine whether or not any of these procedures shall be followed. The directors alone have the power to determine initially whether it is desirable to dissolve the corporation, to merge or consolidate it with, or sell its entire assets to, another corporation. The directors alone also usually negotiate the terms of merger or consolidation or the agreement for the sale of the corporate assets. Thereafter, the decision of the directors and the terms of the merger, consolidation or sale of assets are submitted for the approval of stockholders owning a prescribed proportion of the corporate securities entitled, under the statutes, to vote upon the proposal. Moreover, in most states where the mergers, consolidations, and sales of the entire assets of corporations are regulated by statutes, in the case of a merger or consolidation dissenting shareholders of the corporations involved, and, in the case of a sale of assets the dissenting stockholders of the selling corporation, have the privilege, if the technical procedure of the statutes is complied with, to receive in cash an appraised value of their securities in the absorbed companies.[8]

Code (1932) § 25–1602; Mich. Comp. Laws § 9773; N. C. Code (1931) § 3924 (d). Only in West Virginia are securities issued in connection with a merger, a recapitalization, a rearrangement of capitalization, a reorganization "or any other plan or proposal for the readjustment of the finances" of a corporation required to be registered (W. Va. Code (1931) c. 32, Art. 1, § 11), although in Iowa securities issued in connection with mergers and consolidations are exempt, subject to the approval by the secretary of state of any proposed plan of consolidation or merger (Iowa Code (1935) c. 393, § 8581). Earle Bailie, the chairman of the board of directors of Tri-Continental Corporation, in his testimony indicated the necessity for "disclosure of all pertinent information in connection with charter amendments, * * * mergers, acquisitions, and reorganizations when submitted for approval of shareholders" (Public Examination, Tri-Continental Corporation, at 18767).

[6] See *Parker Corporation Manual,* 1938, passim.

[7] See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), Part VII, Appendix B, Secs. II, III, and IV, p. 526 et seq.

[8] Ibid. See, e. g., Md. Code Ann. (Flack Supp. 1935), Art. 23, §§ 33–35.

3. NONREGULATION OF SALES OF ASSETS OF "MASSACHUSETTS" BUSINESS TRUSTS

The state statutes, however, usually relate only to corporations.[9] No provision is made for the dissolution, merger, or consolidation of business trusts (also known as common law or "Massachusetts" trusts),[10] a form of organization adopted by many investment enterprises. As of December 31, 1936, the 152 investment companies in existence with assets in excess of $500,000 included 20 business trusts or "Massachusetts" trusts owning assets valued on a market value basis at approximately $218,000,000, the equivalent of 12.2% of the total assets of all 152 companies.[11] The power of these trusts to be dissolved, or sell their assets to other trusts or corporations, is found only in their trust indenture. Normally, the trust indenture is prepared by the management of the trust and reflects the attempt of the sponsor and trustees to secure the broadest possible latitude in the administration of the trust's assets. As a consequence, such trust indentures usually permit the trustees to terminate the trust's existence and sell its assets to another trust or corporation without the sanction or prior approval of the certificate holders. Thus, of the 20 investment companies of the "Massachusetts" trust type with assets in excess of $500,000 each on December 31, 1936, 14 were terminable by the action of their trustees alone. In only five cases was notice of termination required to be given to the certificate holders. In only two trusts were the certificate holders given a voice as to the trust's termination, and in these cases the trust was terminable only with the consent of the holders of 75% of the outstanding certificates. As an incident of termination, most of the trust indentures permit the trustees alone, without the prior approval of the certificate holders, to transfer the entire trust assets to another trust or corporation for either cash or the securities of the purchasing trust or corporation. The indenture of Massachusetts Investors Trust, which is typical, provides:[12]

> * * * The power * * * is hereby expressly vested in the Trustees in their discretion to terminate the Trust * * * by an instrument in writing, setting forth such termination, signed by all of the Trustees * * * and by notifying all the shareholders of record of such termination.
>
> Upon the termination of this Trust either by expiration or otherwise, the Trustees in their discretion may: (a) Convey the fund to new or other Trustees or to a Corporation * * * and distribute the proceeds received therefrom * * *.

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[9] However, in 1937 the Delaware legislature amended its general corporation law to permit the merger or consolidation of a corporation incorporated in Delaware with joint stock associations, unincorporated associations, and trusts having outstanding shares of stock or other evidences of financial or beneficial interest therein (Del. Rev. Code (1935) C 65, Section 59–B). Under the statute, certificate holders of business trusts merging or consolidating with a Delaware corporation, who dissent to the merger or consolidation, are entitled, if the statutory procedure is followed, to receive in cash an appraised value of their certificates (ibid.).

[10] For a brief discussion of "Massachusetts" type investment trusts, see Part One of this report (House Doc. No. 707, 75th Cong.), p. 23.

[11] See Part Two (House Doc. No. 70, 76th Cong.), Ch. II, Table 26, p. 125.

[12] Reply to the Commission's questionnaire for Massachusetts Investors Trust, Pt. I, Exhibit 2, p. 23.

Thus, the certificate holders of the business or "Massachusetts" trust type of investment company have no voice in a possible reorganization of their company by a conveyance of its assets to another investment trust or company. Nor do they have the right usually accorded to stockholders of corporations in the same situation, to secure an appraised value of their shares in cash.[13]

4. CONFLICTS OF INTEREST IN MANAGEMENT PREPARED REORGANIZATION PLANS

Obviously, the state statutes contemplate the use of these procedures only when, in the opinion of an independent unbiased management, they are in the best interest of the corporation and its stockholders. The statutes presume that the directors of the several corporations involved in negotiations for a merger, consolidation, or a sale of assets are acting at arm's length in an endeavor to secure the best possible bargain for their respective stockholders. Where, however, several corporations are under common control and the managements of subsidiary corporations are in effect the mere nominees of the controlling corporation, the possibility of a dissolution, merger, consolidation, or sale of the assets of one or more of the subsidiary corporations which is disadvantageous to minority stockholders becomes apparent. Such common control may be the result of investment company acquisition campaigns. One essential step in such campaigns is the elimination of independent representation of stockholders of the acquired companies by inducing, by methods which have already been described, the former managements of such companies to relinquish control to the acquiring corporation. Thereafter, the terms of the exchange offers and the terms of the eventual merger or consolidation are fixed solely by the controlling company. Minority stockholders are without unbiased representatives to negotiate the terms of either exchange offers or merger agreements. In this situation the intent and spirit of the state merger and consolidation statutes may be substantially nullified. Indeed, where exchange offers are used as a preliminary to an eventual merger, consolidation, or dissolution, such offers in themselves constitute essentially the terms upon which the security holders will be permitted to retain a permanent investment in the assets of their their former companies. The merger, consolidation, or dissolution of their companies following the exchange offers usually is merely a formal legal procedure for eliminating those stockholders who have not exchanged or sold their securities to the controlling company.

Nor are the cases in which common control exists the only situations in which a conflict of interest adverse to minority stockholders may obtain. When the managements of investment companies hold securities of a class different from those held by the public, an antagonism of interests may occur which may be reflected in a merger or consolidation plan favorable to the management's securities at the expense of the public's holdings. Or the plan may openly or secretly provide special consideration or treatment to the managers or sponsors in consideration of their agreement to approve a

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[13] See, however, note 9, supra. In only rare cases do the certificate holders of "Massachusetts" trusts have the right to vote on any trust matter.

plan which may be detrimental to the stockholders of their company. Managements may be accorded more advantageous treatment by the acquiring company than may subsequently be given to public holders of the same securities;[14] they may be promised a continuance of the brokerage business or a participation in the future underwriting of additional securities of the combined company or of companies controlled by such company. They may receive, in addition, secret commissions for soliciting acceptance of the merger or consolidation plan by the stockholders of their companies. In addition, undisclosed agreements providing for more advantageous terms may be made with influential or large security holders who, while not connected with the management of their company, have sufficient voting strength to block a proposed merger or consolidation. Finally, the purpose of the merger or consolidation may be to increase the management's control of industrial or financial corporations, a purpose which may not be compatible with the interests of stockholders.

5. ABSENCE OF INDEPENDENT APPRAISAL OF PLANS PRIOR TO SUBMISSION TO STOCKHOLDERS

Notwithstanding the possibilities of abuse inherent in the preparation of plans of merger or consolidation of investment companies by managements whose interests may be adverse to those of stockholders, or of a particular class of stockholders, few state and no federal laws make any provision for an independent appraisal of the fairness of such plans to all parties in interest by any administrative or judicial body, prior to the submission of the plan to a stockholders' vote.[15]

The possibilities of abuse inherent in the fact that plans of merger or consolidation are prepared by managements whose stock and other interests in the company may conflict with those of the public stockholders, are indicated in the testimony of O. Kelley Anderson, president of Consolidated Investment Trust. This investment company had been formed on October 17, 1933, as a consolidation of The Kidder Peabody Acceptance Corporation, Kidder Participations, Inc., Kidder Participations, Inc., No. 2, and Kidder Participations, Inc., No. 3, all of which were sponsored prior to 1931 by

[14] See the cases discussed supra, Sec. III.

[15] In only three states, Iowa, West Virginia, and South Carolina, is there provision made for the submission to the scrutiny of an administrative body of plans of reorganization, recapitalization, or for a merger or consolidation. The Iowa Securities Act exempts from registration securities issued in connection with a merger or consolidation subject to the approval by the Iowa Secretary of State of any proposed plan of merger and consolidation. The Secretary of State is empowered to demand information necessary to assist him in determining that such plans comply with the Iowa Securities Act (Iowa Code (1935), c. 393, § 8581). The West Virginia Securities Act requires registration of securities proposed to be issued in connection with a reorganization, recapitalization, merger, rearrangement of captalization, or any other plan or proposal for the readjustment of the finances of a corporation, and empowers the State Securities Commissioner to require any change to be made in such plans as he deems necessary for the protection of the interests of investors (West Virginia Code (1931), c. 32, Act 1, 311). The South Carolina law empowers the State Insurance Commissioner to hold hearings upon and to approve the fairness of the terms and conditions of any plan of reorganization or recapitalization of any corporation organized, domiciled, or having its principal place of business within the state (South Carolina Securities Act, Laws 1936; Act No. 768, § 11).

Kidder, Peabody & Co., a Boston investing banking house.[16] In 1931, Kidder, Peabody & Co. was reconstituted and terminated its management of these corporations.[17] The new directors, however, headed by Roger Amory,[18] were the same for all four companies and acquired substantial interests in the various securities of these companies.[19] The assets of all four corporations consisted essentially of holdings of then unmarketable securities[20] of companies for which Kidder, Peabody & Co. had been or were the bankers.[21] The value placed on these securities for the purpose of the consolidation would directly affect the value of the securities of the various companies and form the basis for the terms of the consolidation. Although it is not to be implied that the consolidation was unfair,[22] Mr. Anderson testified with reference to the preparation of the plan of consolidation of these four companies, as follows:[23]

Q. Did you participate in the formulation or the promulgation of the terms of the consolidation?

A. Well, I had something to do with them. I was just working on them as an officer of the corporation.

Q. Now, as I see it, these Participations corporations and the Acceptance Corporation had a very substantial part of their funds invested in these illiquid, concentrated special situations.

A. That is right.

Q. Who appraised these situations in order to determine the ratios of exchange of the securities?

A. The officers and directors did. At the time we were determining whether we would consolidate or not. The main difficulty with any consolidation was coming to any correct basis for exchange; that is, allocation of any stock between the four companies, and we considered whether we should have a stockholders' committee do that, whether we should do it directly on the basis of an auditor's report, or whether we should use the best judgment of the officers and directors. They seriously considered all three and thought the best thing to do was to use the best judgment of the officers and directors. There were so many special situations in there that you would have an entirely different idea of appraising them than I would—the stockholders would have one idea and the auditors another idea.

Q. So that there was no independent body which passed on the merits, fairness, or equality of the plan, except that there was a stockholders' meeting called.

A. Yes; and numerous stockholders came in and talked to us about it.

Q. Well, did the new officers and directors have substantial security positions in these companies?

A. Yes.

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[16] Public Examination, Consolidated Investment Trust, at 20109–13.

[17] Id., at 20105, 20171.

[18] Id., at 20171–2.

[19] Id., at 20186. For example, Roger Amory, one of the directors, owned or represented "$151,500 worth of the Class 'B' preferred stock of the Acceptance Corporation; $2,000 of securities preferred stock of the Acceptance Corporation; $4,500 of preferred stock of Kidder No. 1 and 200 shares of common stock of Kidder No. 3" (id., at 20196).

[20] Id., at 20186.

[21] Id., at 20141–69.

[22] The record indicated that the terms of the consolidation were based on the relative asset values of the various companies which were consolidated to form Consolidated Investment Trust.

[23] Op. cit. supra, note 16, at 20185–7.

Q. Their security position was not equal in each class of security, was it?

A. No.

Q. So that they had a pecuniary interest in the basis of exchange, in that, depending upon the ratio that was fixed.

A. That is right, but I think that was subordinate to their idea of fairness to everyone.

Q. That is assuming that a person has that happy faculty of being so sacrificial that he is willing to make a pecuniary sacrifice in the interest of abstract fairness.

A. All these men had the idea of doing a good thing for the community and not the idea of personal gain.

Q. But it is a fact that their holdings were such that they either stood to lose or gain upon the ratio fixed for each class of securities.

A. That is true of any consolidation.

Q. It is true of any consolidation provided it is not submitted to some impartial, independent body to pass upon.

A. In connection with that, I would like to point out that under Massachusetts law, any stockholder who objects to any consolidation has the right to file an objection and have his stock appraised and receive cash for the same.

Q. That is all predicated upon the assumption that he has the requisite amount of legal training and is conscious of the existence of those provisions.

A. We knew that many of them did not know that and we told them about it.

The acquisition by General Investment Corporation, through the medium of an exchange offer of securities, of nearly all of the stock of United States & Overseas Corporation, is also illustrative of the conflicts of interest which arise between the management and the public stockholders of an investment company in the preparation of plans for the merger or consolidation of their company with another company.

General Investment Corporation, which was originally known as The Public Utility Holding Corporation of America, was incorporated in Delaware on September 5, 1929, under the sponsorship of The Harris Forbes Corporation, an affiliate of Harris, Forbes & Co., investment bankers, and United Founders Corporation and its subsidiary, American Founders Corporation.[24] By September 1930 General Investment Corporation had issued approximately 3,000,000 shares of common stock for proceeds of approximately $54,000,000,[25] and 500,000 shares of Class A stock for proceeds of $6,250,000.[26] All of the Class A stock, which at all times was entitled as a class to cast a vote equal to 66⅔% of the number of shares of common stock outstanding,[27] was acquired by the sponsors of General Investment Corporation, The Harris Forbes Corporation, and the United Founders Corporation group of investment companies.[28] All of the directors and

[24] Public Examination, American General Corporation, Commission's Exhibit No. X3423. On July 21, 1933, the name of the corporation was changed to General Investment Corporation.

[25] See Ch. II of this part of the report, pp. 497–623.

[26] Public Examination, American General Corporation, Commission's Exhibit No. X3424 (p. 12).

[27] Id., Commission's Exhibit No. X3423–I. The common stockholder was entitled to one vote per share.

[28] Id., Commission's Exhibit No. X3424 (p. 12).

officers of General Investment Corporation were representatives of The Harris Forbes Corporation and the United Founders Corporation group of investment companies.[29]

In January 1929 The Harris Forbes Corporation and the United Founders Corporation group of investment companies had also participated in the formation of United States Overseas Corporation,[30] which had been organized to extend intermediate credits to foreign industries, particularly in Germany.[31] By September 1930, United States & Overseas Corporation had issued 750,000 shares of common stock for proceeds of $19,200,000 [32] and 300,000 shares of Class A common stock for $3,000,000.[33] The common stock was entitled to a priority in liquidation to an aggregate of $19,200,000, an amount equal to the proceeds of the sale of this stock, but enjoyed no priority in dividends nor did it share in undivided profits on liquidation.[34] The Class A stock was entitled to 33⅓% of the combined voting power of both classes of stock and was junior to the common only on liquidation.[35] As will be discussed later, both The Harris Forbes Corporation and the United Founders Corporation group of investment companies held large blocks of both classes of stock of United States & Overseas Corporation.

By November 1930 United States & Overseas Corporation had invested approximately $14,000,000 in "intermediate credits" to German companies.[36] By the autumn of 1930 the investment quality of German "intermediate credits" was at least questionable. F. S. Burroughs, president of General Investment Corporation, testified that it was possible that General Investment Corporation "would not have looked for more German credits at that time." [37]

However, Harris, Forbes & Co., in September 1930, were of the opinion that the German credits held by United States & Overseas Corporation were sound investments.[38] Harris, Forbes & Co., therefore, adopted the suggestion of the Deutsche Bank,[39] one of the sponsors of United States & Overseas Corporation, that that corporation be combined with General Investment Corporation on the ground that there would be "less companies." [40] To accomplish this combination, General Investment Corporation, on September 8, 1930, offered to exchange (a) a package consisting of 3 shares of its preferred stock, 5 shares of its common stock, and warrants to purchase 7 shares of its

[29] Id., Commission's Exhibit No. X3762.

[30] Id., at 25356, 25366, and Commission's Exhibit No. X3959.

[31] Id., at 25356.

[32] Id., Commission's Exhibit No. X3960.

[33] Ibid.

[34] Id., Commission's Exhibit No. X3959.

[35] Ibid.

[36] Id., Commission's Exhibit No. X3966, A–2.

[37] Id., at 25469–70. James Warburg, a director of American and Continental Corporation, another of the United Founders Corporation group of companies which had extensively lent its funds to German industry, stated that the competition among various banking houses making German loans had caused a decline in the attractiveness of such investments, and, in fact, that by the autumn of 1930 German credits had saturated the American market. Moreover, he stated that growing political unrest in Germany was a factor then affecting the value of German loans (id., Commission's Exhibit No. X4246, pp. 28, 30, 31).

[38] Id., at 25357.

[39] Id., at 25467.

[40] Ibid.

common stock for each 10 shares of United States & Overseas Corporation common stock, and (b) 5 shares of its preferred stock and warrants to purchase 24 shares of its common stock for each 24 shares of United States & Overseas Corporation's Class A stock.[41] Eventually General Investment Corporation acquired all the Class A stock and 97% of the common stock of United States & Overseas Corporation as a result of this offer plus some small cash purchases.[42]

The ratios and classes of securities to be exchanged were determined by representatives of The Harris Forbes Corporation and of the United Founders Corporation group,[43] at a time when these organizations controlled General Investment Corporation and were the principal sponsors of United States & Overseas Corporation. Both The Harris Forbes Corporation and the United Founders Corporation group had a substantial pecuniary interest in the terms of the exchange because of their ownership of blocks of the Class A stock and common stock of United States & Overseas Corporation and their ownership of blocks of Class A stock and common stock of General Investment Corporation. On September 8, 1930, the United Founders Corporation group owned 75,000 shares of the Class A and 173,221 shares of the common stock of United States & Overseas Corporation, and 250,000 shares of the Class A and 743,586 shares of the common stock of General Investment Corporation;[44] The Harris Forbes Corporation held 36,667 shares of the Class A and 53,125 shares of the common stock of United States & Overseas Corporation, and 250,000 shares of Class A and an unknown amount of common stock of General Investment Corporation.[45]

The terms of the exchange offers were apparently favorable to the holders of the securities of United States & Overseas Corporation, particularly to the holders of the Class A stock of United States & Overseas Corporation, more than one-third of which was held by The Harris Forbes Corporation and the United Founders Corporation group of investment companies. The exchange for the common stock of United States & Overseas Corporation was made on an equal asset value basis.[46] For the purposes of the exchange, the intermediate German loans, which constituted about two-thirds of the assets of United States & Overseas Corporation, were valued at their cost.[47] However, the preferential value in liquidation of the preferred stock which was exchanged by General Investment Corporation for the Class A stock of United States & Overseas Corporation was substantially in excess of the liquidating value of the Class A stock

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[41] Id., at 25464.

[42] Id., Commission's Exhibits Nos. X3966–A, X4111.

[43] The terms of the exchange were negotiated by E. Carlton Granbery of Harris, Forbes & Co. acting on behalf of United States & Overseas Corporation, and Frederick Burroughs of Harris, Forbes & Co., and George Devendorf of the United Founders Corporation group acting on behalf of General Investment Corporation (id., at 25468).

[44] Id., Commission's Exhibits Nos. X3927, X3424 (p. 27).

[45] Id., Commission's Exhibit No. X3424 (p. 71). The Harris Forbes Corporation allotted the common stock of General Investment Corporation to its own stockholders. Their disposition of the stock is for the greater part unknown to the Commission although Mr. Burroughs testified that the stock was allotted subject to a sales restriction agreement.

[46] Id., at 25465–6.

[47] As at November 30, 1930, net assets of United States & Overseas Corporation totaled $20,965,531, of which approximately $14,500,000 represented the face value of loans made to German and other foreign companies (id., Commission's Exhibit No. X3966).

received. The 62,500 shares of its cumulative preferred $3 dividend shares with a liquidating preference in assets of $3,593,750 issued by General Investment Corporation [48] exceeded the then liquidating value of the 300,000 shares of Class A common stock of United States & Overseas Corporation received in exchange for this General Investment Corporation preferred stock. Although The Harris Forbes Corporation and the United Founders Corporation had a substantial investment in the stock of General Investment Corporation, this exchange resulted in burdening the public holders of the common stock of General Investment Corporation with an excessive cost for the Class A stock of United States & Overseas Corporation purchased from the management of General Investment Corporation and from others associated with them in the sponsorship of the United States & Overseas Corporation. Mr. Burroughs testified: [49]

Q. The figures that we have here, Mr. Burroughs, indicate, and we will let you figure them out for yourself if there is any question about it, that the common shares of U. S. & Overseas had a liquidating value of $25.60, and that left a stated value of about $9.79 per share of Class A.

A. What date was that?

Q. This was November 30th, 1930.

A. That $25.60 figure that you have is familiar to me. I seem to remember that.

Q. That is the preference in value over Class A.

Q. Now, if the stated value and surplus and undivided profits of U. S. & Overseas were $22,000,000, and there were 750,000 shares of common, that would have left a value of $9.79 per share of Class A on liquidation. Now, if a block of 24 shares of Class A would accordingly have $234.96, that is 24 times $9.79 for this block, the Class A shareholders received five shares of P. U. H. [Public Utility Holding Corporation, subsequently known as General Investment Corporation] preferred, which was entitled on liquidation to $57.50, which was a total of $287.

A. The par was $50. It was only entitled to $57.50 at most on liquidation, but we only figured the par value, because that is the basis.

Q. Yes; I realize that there might have been some reason. I was just pointing out there was a difference in liquidating value of about $50 on the 24 shares of Class A over what they had had in U. S. & Overseas.

A. Well, we had to make some inducement over their bare asset value.

Q. So your idea was, as far as this offer of exchange to U. S. & Overseas, was an offer the P. U. H. wanted very much to go through, that inducement had to be made to U. S. & Overseas stockholders?

A. Yes; P. U. H. was anxious to do it because it increased our assets, increased the resources of the company, made it larger, and we were at that time anxious to have more capital.

Q. Mr. Burroughs, my attention is called to the fact that at a subsequent time the P. U. H. Corporation wrote down its portfolio $2,548,502.90 to adjust the U. S. & Overseas holdings to their asset value. Do you recall anything about that?

A. That was quite a bit later, wasn't it?

Q. It was quite a bit later?

A. Yes.

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[48] Id., Commission's Exhibit No. X3423–5b (p. 10).

[49] Id., at 25470–2.

Q. But it does show there was an excess over asset value, the price at which it was taken over?

A. I think quite probably there was an excess even at the time of the exchange, * * *.

Any dilution in the asset value of the sponsors' holdings of General Investment Corporation common stock as a result of the exchange was, to some extent at least, compensated by the fact that they received 87,976 shares of the preferred stock of General Investment Corporation having a total preferred liquidating value of $5,058,620,[50] in exchange for their United States & Overseas Corporation common and Class A stock.[51]

United States & Overseas Corporation was subsequently liquidated by the surrender of its capital shares held by General Investment Corporation in exchange for its assets valued at cost. General Investment Corporation recorded a loss of $2,886,221.16 on its holdings in United States & Overseas Corporation shares by the time United States & Overseas Corporation was liquidated in May 1934.[52]

In addition, losses of $6,385,386.50 were eventually sustained by General Investment Corporation on German credits which it acquired from United States & Overseas Corporation.[53]

Apparently in recognition of the fact that the statutes, by confining to corporate managements alone the power to fix the terms of mergers, consolidations and sales of corporate assets, may result in overreaching of the stockholders by managements, state laws in many cases permit shareholders dissenting from merger plans to receive an appraised value of their shareholdings in cash. However, the state laws are not uniform in this respect. Thus, only 26 of the 31 states which authorize corporations by general statute to merge or consolidate upon approval of a specified number of stockholders, provide appraisal rights for dissenters. Similarly, only 25 of the 40 states (including the District of Columbia), having statutes permitting the sale by a corporation of all its assets, extend appraisal rights to dissenting stockholders. And in 8 (including Delaware) of the 30 states

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[50] Id., Commission's Exhibit No. X3424 (p. 71).

[51] Ibid. The Class A stockholders of United States & Overseas Corporation received a completely preferred position in General Investment Corporation, and the common stockholders of United States & Overseas Corporation, including the United Founders Corporation group and Harris, Forbes & Co., received in return for their stock a preponderantly preferred position in General Investment Corporation. For each 10 shares of their common stock in United States & Overseas Corporation having a total asset value of $265 (id., Commission's Exhibit No. X3966, p. 3), General Investment Corporation issued in addition to common stock 3 shares of its preferred stock having a liquidating preference of $172.50. Mr. Burroughs testified (id., at 25473):

> Q. Then what happened actually was that these persons who held a junior interest in U. S. & Overseas, were given a senior interest in Public Utility Holding Corporation, and at a price in excess of the asset value that they turned in?
> A. To both classes of U. S. & Overseas we gave them senior securities of P. U. H. [Public Utility Holding Corporation, subsequently known as General Investment Corporation]. We considered it just as though we were buying the portfolio from them, just as though we were buying the portfolio from U. S. & Overseas.
> Q. That was the reason for giving them this senior stock?
> A. That is correct; yes.
> Q. However, that technique does not admit of this situation at a time when possibly matters cannot be settled in case that a person is given a junior interest in one corporation, if he is an insider, will be given a senior interest in another corporation by an allied group and thereby taken from an unpreferred into a preferred position?
> A. Well, he might have received cash, which would be definitely senior.

[52] Id., Commission's Exhibit No. X4111.

[53] Id., Commission's Exhibits Nos. X3970, X3424 (p. 61, et seq.).

which authorize both merger (or consolidation) and sale of assets by action of the majority stockholders, provisions are made for appraisal in the case of merger or consolidation but not sale of assets, while one state provides for appraisal in the event of a sale of assets, but not in the case of merger or consolidation.[54]

As a result of this diversity in state laws, stockholders in particular states may be substantially without protection against unfair plans of merger, consolidation, or sale of assets. And where appraisal rights in a particular state are not accorded in all of these procedures, managements proposing unfair plans have an opportunity to resort to that procedure which will be most advantageous to themselves and perhaps least advantageous to the stockholders. Thus, in Delaware, the situs of incorporation of approximately half of the existing investment companies,[55] stockholders dissenting to a plan of merger or consolidation [56] have a right to an appraisal; on the other hand, no appraisal rights are granted in the case of a sale of assets, a procedure which will accomplish the same ends as a merger or consolidation.[57] Obviously, managements of Delaware corporations will tend to utilize the sale of assets technique. Later in this section there will be described instances of the conscious adoption of the sale of assets procedure in order to avoid payment of appraised valuations of dissenting stockholders' securities.

Even where obtainable, the remedy by appraisal is an inadequate one. The statutes do not require that stockholders be informed of their right of appraisal.[58] In many cases, therefore, the stockholders may be unaware of the existence of the right. Even if stockholders are cognizant of their right to an appraisal, the procedure prescribed by the statutes for obtaining it is highly technical and costly. Stockholders who fail to exercise their right to appraisal, whether from ignorance, inadvertence, or failure to comply strictly with the technical procedure for obtaining the right, are bound by the terms of the merger, consolidation, or sale of assets,[59] unless the transaction is set aside by a court of equity on a suit of a stockholder as inequitable. As the Commission has pointed out in another of its reports: [60]

> * * * From the point of view of dissenting minority stockholders, the statutory appraisal remedy is inadequate. This inadequacy is due in part to the narrow function of the appraisal remedy generally. It is a remedy which does not prevent or set aside inequitable corporate readjustments. At best it merely provides minority stockholders with the means of escaping from the operation of an unfair plan by selling out at a fair price. The stockholder who desires to retain his investment and share in the future prosperity of the venture which he helped finance is still relegated to the uncertain and costly process of litigation for protection against an inequitable readjustment plan. Even this opportunity is denied him in one or two states which provide that resort to the appraisal statutes shall be an exclusive remedy.

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[54] See the Commission's Report of the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, p. 593.

[55] See Part One of this report (House Doc. No. 707, 75th Cong.), p. 63.

[56] Del. Rev. Code (1935), c. 65, § 61.

[57] Id., § 65.

[58] Op. cit. supra, note 54, p. 601.

[59] Ibid.

[60] Id., p. 610.

The appraisal remedy also fails to fulfill the narrow function which it is designed to serve. In the first place, its scope is limited. Not all states have appraisal statutes and the great majority of those which do have them fail to extend the remedy to all types of corporate action which drastically affect stockholder rights, * * *.

Finally, even where the remedy of appraisal is clearly available, its realization is difficult. There are no provisions requiring notice to be given to stockholders advising them of their appraisal rights. Consequently, many stockholders probably never become aware of the existence of such rights. And the procedure prescribed by the statutes is complicated. In order to perfect his appraisal rights, it is usually necessary for the stockholder to dissent from the proposed action either by negative vote at the meeting or by written objection. Thereafter, the procedure typically prescribed requires a written demand on the corporation for payment, and application to the proper tribunal for appointment of appraisers in the event that the corporation, in response to the demand for payment, makes no offer or makes an offer that is unacceptable to the stockholder. Statutes requiring a specific negative vote may have the effect of making compliance extremely difficult for voting stockholders by forcing attendance at the meeting in person or by special agents; and in a few instances, such statutes may operate to deprive non-voting stockholders of the remedy altogether. The valuation proceedings are protracted and costly, and in many instances, dissenting stockholders lose the benefit of their investment for the entire period consumed by such proceedings.

The right to an appraisal of the value of his shares may not be the only remedy of a stockholder dissenting from a dissolution, merger, consolidation, or sale of the entire or substantially all of the assets of his corporation. He may in a proper case seek judicial relief in the form of an injunction restraining the proposed transaction. In Michigan and California, however, the law provides that the appraisal right shall be the only and exclusive remedy of a stockholder dissatisfied with the terms of a proposed merger or consolidation of his corporation.[61]

However, resort to judicial proceedings, where possible, is expensive and usually beyond the means of the average investor who normally cannot afford to retain counsel of the experience and caliber available to the management or to the majority stockholders proposing the transaction with which the stockholder is in disagreement. And the ascertainment of the names of other stockholders who might share the expense of a suit or the formation of a protective committee may be difficult. The list of stockholders is usually under the control of the management and may be obtained only after judicial proceedings, which are in themselves costly. Against these difficulties which may confront the stockholder, the management usually has available to it the funds of the corporation to aid it in resisting suits. And stockholders who actually sue, although they do so technically in behalf of themselves and all other stockholders, usually are interested in their own welfare only. As a consequence, the actions of suing stockholders in many instances may be settled by managements who fear that a case for equitable relief is clear or probable. Thus, The Equity Corporation which, in November 1935, caused the

[61] Id., p. 609.

consolidation of several of its controlled companies, primarily United Founders Corporation and its subsidiaries, to form American General Corporation, encountered opposition to its plan. In a number of aspects, which will be described more fully later, the plan was unfavorable to the stockholders of the companies controlled by The Equity Corporation. Stockholders of several of the companies involved brought suits to obtain an injunction restraining the consolidation. As the Commission has reported elsewhere:[62]

It is a reasonable inference that the continuation of these proceedings with resultant court hearings might have been disastrous to Equity's plans. Attendant publicity might have led other stockholders to institute proceedings. And, of course, issuance of a permanent injunction would have meant an end to the entire transaction. In any event, the Equity Group was evidently anxious to avoid a court test of the legality of the consolidation. It proceeded to settle the case * * *.

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* * * A total of $338,237.23 was ultimately paid for the securities involved in the settlement.

A comparison of the sum paid in settlement of this litigation with the asset and market value of the securities of American General Corporation that these stockholders would have received if they had exchanged their holdings pursuant to the terms of the consolidation shows further how far the inside group was prepared to go to dispose of these suits. The American General securities which these security holders would have received under the terms of the consolidation agreements had an asset value as of December 31, 1935, of $259,009.43, and a market value as of the same date of $161,931.68. Thus the sum paid these security holders was approximately $80,000 in excess of the asset value and $176,000 in excess of—or over twice the market value of—the securities which they would have received under the plan.

And similar evidence is to be found in a comparison of the sum paid in settlement of the litigation and the settlements made with security holders who claimed a statutory right to receive payment and appraisal of their shares. A complete comparison is not possible because the same number of securities of the same companies was not involved in both proceedings. Insofar as the comparison can be drawn, however, it appears that the sums paid in settlement of the injunction suits were relatively larger.

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But analysis of the term of settlement emphasizes another point in addition to the extent to which the inside group were prepared to go to dispose of these suits. The third of a million dollars which was paid in settlement of these claims was not paid by the group that had engineered the consolidation. The terms of the settlement were met with funds of the American General Corporation, the consolidated company. Realistically, therefore, subject to The Equity Corporation's interest as a stockholder in this company, the settlement was paid out of the funds of the stockholders who had been forced into the consolidation. Their funds were used to settle litigation, which, if it had been prosecuted to its termination, conceivably might have resulted in the entire transaction being set aside. Their funds were used in effect to provide a preference for the stockholders who had challenged the plans of the insiders. And, finally, their monies were used to continue impregnable the control and domination of the insiders.

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[62] Id., pp. 333–6.

Managements may thus avoid a judicial test of their plans by the process of settling with the corporate funds the actions or claims of such stockholders who are financially able to afford the expense of a suit. To this extent, the effectiveness of litigation as a remedy for all stockholders is substantially diminished. And the probability of ultimate relief, assuming that suits are pressed to their conclusion, is uncertain. Unless the steps taken by the management to effect a dissolution, merger, consolidation, or sale of assets, are not in compliance with statute or are for other reasons procedurally illegal, relief can be granted only if the substantive aspects of the transaction are so inequitable as to indicate actual fraud or bad faith upon the part of the management. In general, it may be said that if the statutory requirements are fulfilled and the requisite number of stockholders approve a dissolution or a sale of the corporate assets, the tendency of the courts has been to sustain the action of the majority stockholders irrespective of their motives and however injurious their action may be to minority stockholders.[63] In a few cases, however, courts have on equitable considerations restrained dissolutions or sales of corporate assets where the transaction was engineered by majority stockholders for the purpose of "freezing out" minority stockholders,[64] or with the specific intent to depress the value of the dissenting stockholders' shares,[65] or where the sale price was so grossly inadequate as to suggest fraud.[66] Similarly, proposed plans of merger or consolidation will not be enjoined unless actual fraud or bad faith upon the management or majority stockholders is shown. Mere unfairness in the plan is not enough; the unfairness must be so gross as to indicate bad faith or fraud on the part of proponents of the plan.[67]

The net effect of the decisions is to place the burden of proof of fraud or bad faith upon the suing stockholder. This burden may be difficult for the stockholder to sustain. As the Commission has stated elsewhere:[68]

Since the management is normally the proponent of a merger or consolidation plan stockholders who are attacking such plan may find it difficult to attain access to the books and records of the corporation. Without such access, however, it may be impossible either to furnish affirmative evidence of unfairness or to refute ingenious arguments advanced by the management in justification of the plan. Moreover, despite frequent restatement of the equitable principles which prohibit the fraudulent or oppressive exercise of corporate power, the courts (with some exceptions) appear reluctant to enjoin or set aside mergers or con-

[63] See *Lebold* v. *Inland S. S. Co.*, 82 F. (2d) 351 (C. C. A. 7th 1936); *Windmuller* v. *Standard Distilling and Distributing Co.*, 114 Fed. 491 (C. C. N. J. 1902); Fair, "Limitations of the Statutory Power of Majority Stockholders to Dissolve a Corporation" (1912), 25 Harvard Law Review 677.

[64] *Kavanaugh* v. *Kavanaugh Knitting Co.*, 226 N. Y. 185, 123 N. E. 148 (1919); *Stevenson* v. *Sicklesteel Lumber Co.*, 219 Mich. 18, 188 N. W. 449 (1922); cf. *Theis* v. *Spokane Falls Gas Light Co.*, 34 Wash. 23, 74 Pac. 1004 (1904); *Allaun* v. *Consolidated Oil Co.*, 16 Del. Ch. 318, 147 Atl. 257 (1929).

[65] See *Kavanaugh* v. *Kavanaugh Knitting Co.*, 226 N. Y. 185, 123 N. E. 148 (1919).

[66] See *Allied Chemical & Dye Corporation* v. *Steel & Tube Company*, 14 Del. Ch. 1, 120 Atl. 486 (1923).

[67] See *MacFarlane* v. *North American Cement Corporation*, 16 Del. Ch. 172, 157 Atl. 396 (1928); *Colby* v. *Equitable Trust Co.*, 124 App. Div. 262, 108 N. Y. Supp. 978 (1st Dept. 1908); cf. *Outwater* v. *Public Service Corporation of New Jersey*, 103 N. J. Eq. 461, 143 Atl. 729 (1928) aff'd 104 N. J. Eq. 146 Atl. 916 (Ct. Errors and App. 1929).

[68] Op. cit. supra, note 54, p. 556.

solidations on these grounds. The traditional hesitancy of the courts to interfere with corporate management has doubtless been a contributing factor. In view of the numerous and intricate factors ordinarily involved in a merger or consolidation, the courts have been obliged to attach considerable weight to the opinions of corporate directors and other spokesmen of the management.

As the Commission has further stated:[69]

The courts have not been particularly sensitive to the existence and danger of conflicts of interests among the groups sponsoring merger or consolidations. With respect to the problem of interlocking directorates, the courts uniformly take the position that close scrutiny of proposed mergers or consolidations is necessary where the constituent corporations have common directors. It is generally held, however, that the mere presence of common directors on the boards of the constituent companies, or common control thereof, does not render a merger or consolidation invalid, in the absence of evidence of bad faith or unfairness. In this connection the courts usually reason that since merger or consolidation requires majority stockholder ratification, strict rules governing ordinary contracts between companies having common directors are inapplicable.

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The courts seem disposed to attach considerable importance to the fact that a high proportion of the stockholders have approved the merger or consolidation in question. The fact that a large majority of stockholders support a proposed merger or consolidation is often emphasized by the proponents of the plan in defending it against the attacking dissenters, and many decisions appear to have been influenced by that argument. It seems to be unrealistically assumed that the votes cast (by proxies in most instances) in favor of a proposed merger or consolidation reflect a genuine approval of the plan by stockholders who actually considered its merits. * * *

Moreover, the solicitation material by which consents to a dissolution, merger, or consolidation have been procured may be so adroitly conceived and prepared that, although not fully informative, it will, nevertheless, not receive judicial condemnation. Literature which describes correctly the terms of a merger, consolidation, or other corporate readjustment but omits to explain the significance of such terms with reference to their effect on the value or rights of particular classes of stock, may not be deemed fraudulent by the courts. In a recent decision[70] the Delaware Chancery Court, in a dictum upholding the literature used by a corporate management to solicit proxies to be voted in favor of an amendment to the corporate charter reclassifying outstanding preferred and common stock of a corporation for the purpose of eliminating dividend arrearages on the company's preferred stock, stated:

The other respects in which the letter to preferred stockholders is said to have been infected with fraud and deceit, consist of charges, not of things falsely stated, but of things omitted to be explained. As an illustration it is said that the letter failed specifically to point out to the preferred stockholders that

[69] Id., pp. 552, 554.

[70] *Johnson* v. *Consolidated Film Industries, Inc.*, 194 Atl. 844 (1937) aff'd 197 Atl. 489 (Del. Sup. Ct. 1937). The court granted an injunction declaring void the proposed amendment to the charter of Consolidated Film Industries, Inc., which would have eliminated dividend arrearages on the company's outstanding preference stock on the ground that the Delaware statute authorizing charter amendments did not include within its provisions the power by direct amendment to eliminate dividend arrearages on preferred stock.

if the amendment was adopted they would not be entitled to receive in cash four dollars of the five dollars accumulated on the preferred stock by way of unpaid dividends. There are other particulars in which it is charged that a like and similar omission to explain the effect of the amendment was not plainly pointed out to the stockholders. Now with respect to all of those particulars of omission, which are about eight in number, the general observation is applicable to all but one of them. viz., that the letter accurately laid the facts before the stockholders from which any person who was sufficiently intelligent to raise an inquiry ought to have been able to find his answer. A little bit of thought and some slight arithmetic could have enabled any stockholder to discover from the facts supplied to him by the letter just what the consequences of the proposal would be if it was adopted. If facts which are not highly involved and complicated are truthfully stated, I do not see how fraud can be affirmed because of an omission to state the obvious consequence of these facts.

This approach of the courts implicitly assumes the existence of a substantial degree of understanding of finance and corporate law upon the part of investors. If the consequences of a plan are not clearly described to them, investors through mere inertia, may tend to rely upon their belief in the integrity of their management, a fact of which managements are presumably aware.

The circumstances which have been indicated make it clear that litigation is at best an unsatisfactory and uncertain remedy for stockholders dissatisfied with a management-promulgated plan. The expense of litigation is usually beyond the means of the ordinary investor and the prospects of relief are doubtful because of the difficulties of proof which confront the stockholder. Similarly, the right to an appraisal of the value of his shares is also of small value to the dissenting stockholder. This remedy is also costly and procedurally intricate. And as has been said, at best it merely enables the stockholder to terminate his investment in a corporation at a fair price. It does not, however, avoid the loss by the stockholder of the going value of the assets of his company.

In sum, these voluntary plans of readjustment of the rights and values of the holders of shares of corporations, which may involve a change in the character of a stockholder's investment at least as drastic in nature as that accomplished by a judicial reorganization, are not subjected to the scrutiny of any unbiased authority. In judicial reorganizations, the fairness of the plan is a subject of judicial inquiry. In addition, as the result of recent amendments to the Bankruptcy Act, federal courts supervising corporate reorganizations under Section 77B of the Bankruptcy Act must, if the corporate indebtedness exceeds $3,000,000, submit to the Commission for examination and report the plan or plans which the court regards as worthy of consideration. In fact, the courts may, even in cases where the indebtedness of the debtor corporation is less than $3,000,000, request an advisory report from the Commission. The report of the Commission, if made, is advisory only.[71]

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[71] National Bankruptcy Act of 1898 as amended by Public Act No. 696, 75th Cong., 3d Sess., Ch. X, § 172.

Section 11 (f) of the Public Utility Holding Company Act of 1935 provides that any plan for the reorganization of a registered public utility holding company or any subsidiary thereof for which a receiver or a trustee has been appointed in a court of the United States "shall not become effective unless such plan shall have been approved by

Investment company officials advocated similar safeguards with respect to plans of merger, consolidation, sales of assets or exchange offers. Floyd B. Odlum, the president of Atlas Corporation, testified:[72]

Personally I would welcome some public body or arbiter who could pass on the equities as between divergent interests in such matters as mergers, reorganizations and exchanges of securities, not to substitute their judgment for that of the management, but to see that things are at least within the range of upper and lower limits within which reasonable men can properly differ. * * *

Chase Donaldson, an officer and director of Allied-Distributors, Inc., a corporation engaged in the business of distributing investment-company securities and which aided The Equity Corporation in its exchange offer and merger programs by soliciting through its salesmen and dealers acceptance of The Equity Corporation's offers, testified:[73]

Q. The average small stockholder is not qualified, is he, to pass upon the merits of an exchange? Now take the Equity situation. Do you think the holder of 10 or 15 shares can sit down and figure out whether he is getting a good deal or a bad deal in the Equity exchange?

A. Well, I don't believe I am really in a position to answer that question intelligently. * * *

Q. It was a complex situation, it involved leverage asset value, market value and it involved a balancing of many factors?

A. Yes; it did.

Q. What objection do you see to having some independent agency supervising it?

A. Well, Mr. Schenker, I see no objection to having an independent agency supervising exchanges and reorganizations, providing such agency did not, we will say, in advance have preconceived notions as to what should or should not be done. * * *

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the Commission after opportunity for hearing prior to its submission to the Court." Section 11 (g) of the same Act makes it unlawful to solicit by the use of the mails or the facilities of interstate commerce any proxy, consent, authorization, power of attorney, deposit, or dissent in respect to any reorganization plan of a registered holding company or a subsidiary thereof unless, among other things, each such solicitation is accompanied or preceded by a copy of the Commission's report on the plan or an approved abstract of such report.

Section 6 (a) of the same Act provides that, except in accordance with a declaration effective under Section 7 of the Act and with the order under such section permitting such declaration to be effective, it shall be unlawful for any registered holding company or subsidiary company thereof by the use of the mails or any means or instrumentality of interstate commerce or otherwise directly or indirectly to exercise any privilege or right to alter the priorities, preference, voting power, or other rights of the holder of an outstanding security of such company. Section 7 (e) of the same Act provides that the Commission, if certain other requirements are satisfied, shall permit a declaration to become effective regarding the exercise of a privilege or right to alter the priorities, preference, voting power or other rights of the holders of an outstanding security unless the Commission finds that the exercise of such privilege or right will result in an unfair or inequitable distribution of voting power among holders of the securities of the company or is otherwise detrimental to the public interest or the interest of investors or consumers.

[72] Public Examination, Atlas Corporation, at 18254.

[73] Public Examination, The Equity Corporation, at 10956–7.

B. Dissolution of Investment Companies

The dissolution of a corporation is the voluntary or involuntary termination of its business existence.[74] Upon dissolution, the corporate assets are distributed to the shareholders in accordance with their various security interests in the company. As has been stated, the decision to dissolve is in the first instance made by the corporate directors. Thereafter, state laws require a concurrence in the directors' decision by the holders of a specified percentage of the corporation's voting stock, usually two-thirds of the outstanding voting shares.[75]

Normally, a corporation's existence will be terminated either because of its insolvency or because of the impossibility, for some reason, of pursuing the business enterprise in which the corporation was organized to engage. However, where control of several corporations has been acquired in campaigns of acquisitions, the device of dissolution becomes essentially a method by which minority stockholders of the acquired corporations may be eliminated from the enterprise and the bulk of its assets absorbed by the parent company. The purpose of the dissolution is thus essentially the same as that of a merger or consolidation. The reorganization of the shareholders' interests is essentially accomplished by means of exchange offers of the securities of the parent for its subsidiaries—offers which define the terms of the participation of the stockholders of the subsidiaries in the continuing enterprise represented by the parent company. The actual dissolution eliminates nonexchanging stockholders.

Dissolution is a more attractive procedure than merger or consolidation to the parent company where it owns substantially all of the assets of its subsidiaries. Only a small part of the assets of the dissolved companies will be required for distribution to the minority stockholders, and, unlike the case of a merger or consolidation, the assets of the dissolved corporation will be absorbed by the parent company without the necessity for affording to dissenting stockholders of the parent company a right to receive in cash an appraised value of their shares. Thus the Atlas Corporation absorbed most of its subsidiaries by dissolving them rather than by merging or consolidating them with itself. Of the 19 investment companies whose assets were absorbed by Atlas Corporation, 16 were dissolved and only 3 were consolidated with the parent company.[76] At the dissolution of these companies, Atlas Corporation usually held in excess of 90% of the dissolved companies' securities. The aggregate assets of the dissolved companies at the dates of their dissolution totaled $69,880,-271.36, of which 95.09%, or $66,449,035.49, were distributed to Atlas Corporation and 4.91%, or $3,431,235.87, was distributed to minority stockholders.[77] On the other hand, the interest of minority stockholders in the assets of Pacific Eastern Corporation, Shenandoah Corporation and Sterling Securities Corporation, the three companies which were consolidated with Atlas Corporation, totaled approxi-

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[74] See *Theis* v. *Spokane Falls Gas Light Co.*, 34 Wash. 23; 74 Pac. 1004 (1904).

[75] See, e. g., Del. Rev. Code (1935), c. 65, § 39; Md. Code Ann. (Flack Supp. 1935), Art. 23, § 91.

[76] See supra, pp. 1064–5.

[77] Op. cit. supra, note 72, Commission's Exhibit No. 2001 and derived from supplementary information supplied the Commission for Atlas Corporation.

mately $20,000,000,[78] a sum which would have been withdrawn from Atlas Corporation's control had it dissolved these companies rather than consolidated them with itself. By consolidating them, Atlas Corporation retained these minority assets, since few of the minority stockholders of the consolidated companies elected to receive an appraised value of their shares in cash in lieu of the Atlas Corporation securities offered for their securities under the plan of consolidation.[79]

Similarly, The Equity Corporation dissolved those of its acquired companies in which it held 90% or more of their outstanding securities. According to Chase Donaldson, one of the original sponsors of The Equity Corporation, the dissolution technique was preferred to others because it was a simpler process.[80] But The Equity Corporation employed the dissolution technique only where the outstanding minority was relatively small, so that The Equity Corporation on dissolution would receive the great bulk of the corporation's assets. According to Mr. Donaldson, if there was a substantial percentage of minority holders: [81]

> * * * such as 20 or 30 percent, the merger, even on the same terms prevailing in the exchange, was accorded to them so that the minority stockholders would not be squeezed out by dissolution because in many instances, if the common stocks had no asset value on dissolution, they would have literally been left with nothing. Instead of doing that, The Equity Corporation in most instances had a merger and gave these common stockholders with no asset values some Equity Corporation stock in lieu of merely dissolving the corporation.

However, another practical consideration may explain The Equity Corporation's use of the consolidation method only in cases where the minority stockholders would be entitled to a relatively large proportion of the company's assets. In the case of a dissolution, a large number of minority stockholders might render necessary the payment, as a liquidating dividend, of an amount of cash greater than The Equity Corporation cared to relinquish.

Many state laws require the resolution of a corporate management to dissolve a corporation to be predicated on a judgment that the dissolution is "most for the benefit of the corporation." [82] This decision of the directors, theoretically, must not be merely an execution of the will of the majority stockholders; the rights of minority stockholders must be considered.[83] However, where control of a corporation is acquired by another corporation as a result of the purchase of its shares or of exchange offers of securities, the procedure of dissolution becomes merely an expedient for the effectuation of purposes of the dominant interests which may be prejudicial to minority stockholders. In this situation the directors of the corporation which it is proposed to dissolve are usually the nominees of the controlling stockholders and represent only such stockholders rather than all of the stockholders. And these directors are usually constituted by state

[78] Op. cit. supra, note 72, Commission's Exhibit No. 1989.

[79] Derived from supplementary information supplied the Commission for Atlas Corporation.

[80] Op. cit. supra, note 73, at 10884–5.

[81] Id., at 10872.

[82] See, e. g., Del. Rev. Code (1935), c. 65, § 39.

[83] See *Kavanaugh* v. *Kavanaugh Knitting Co.*, 226 N. Y. 185, 123 N. E. 148 (1919).

laws as the trustees in dissolution of a dissolved corporation.[84] The directors, therefore, will determine the time, place, and manner of dissolution and will also evaluate any nonmarketable corporate assets for the purpose of fixing the distributive shares of the various classes of stock in the corporate assets. Directors who are merely the nominees of a controlling corporation may have the interest of that corporation only in mind. Such interest may seriously conflict with the interest of minority stockholders.

1. MANAGEMENT CONTROL OF TIME OF DISSOLUTION

The time of dissolution of an investment company is of obvious importance. If the company is liquidated at a time of abnormally low market prices for the company's portfolio securities, stockholders will obviously receive less cash than they would have received if the liquidation had occurred in a period of normal market conditions. On the other hand, a controlling corporation which has acquired the security issues of its subsidiaries in order eventually to absorb the latter's assets, although receiving only its pro rata share of the assets, will be desirous of obtaining the securities in the dissolved company's portfolio at the lowest possible price, and of distributing as little as possible of the corporate assets to minority stockholders. In brief, the dominant stockholder has the power to eliminate minority stockholders at a time of low values for the corporate assets.

a. Dissolution by Atlas Corporation of Iroquois Share Corporation

The history of Iroquois Share Corporation prior to the time that it became a subsidiary of Atlas Corporation has been treated in detail elsewhere in this report.[85] To recapitulate briefly, Iroquois Share Corporation was incorporated in Buffalo, New York, in January 1929, under the sponsorship of the then brokerage firm of O'Brian, Potter & Stafford. Its capitalization consisted entirely of common stock of which eventually 158,279 shares were issued for net proceeds to the corporation of $3,503,891.05. By April 1931, the assets of the corporation had depreciated 50% to approximately $1,450,000. Nevertheless, the corporation's portfolio on April 30, 1931, consisted almost exclusively of diversified marketable securities[86] with the exception of the stock of a real estate corporation which Iroquois Share Corporation had purchased from O'Brian, Potter & Stafford in July 1930, at a cost of approximately $300,000 in a transaction by which O'Brian, Potter & Stafford also ceased to be the managers of the corporation.[87]

On April 13, 1931, Atlas Corporation, with the concurrence of the then management of Iroquois Share Corporation, made an exchange offer of its securities for the securities of Iroquois Share Corporation. As a result of this offer, Atlas Corporation acquired a total of 154,328 shares of Iroquois Share Corporation's stock and on May 5, 1931, assumed control of the corporation, replacing existing directors with its own nominees. Although by its offer Atlas Corporation acquired in excess of 95% of the outstanding shares of Iroquois Share Corpo-

[84] See 16 Fletcher, *Cyclopedia Corporations* (1932), § 8174.

[85] See Ch. II of this part of the report, pp. 51–76.

[86] Op. cit. supra, note 72, Commission's Exhibit No. 2043.

[87] See note 85, supra.

ration, 3,951 shares of Iroquois Share Corporation stock were still outstanding in the hands of the public. Without consulting these minority stockholders, Atlas Corporation completely and fundamentally changed the type of investment activity in which Iroquois Share Corporation had formerly engaged. Its diversified portfolio was almost immediately entirely liquidated and replaced with the securities of investment companies whose control Atlas Corporation was then in the process of acquiring. Between April and August 1931, Iroquois Share Corporation at an aggregate cost of $1,123,619 acquired 37,700 shares of the Class B stock of American Investors, Inc., of which 11,500 shares were purchased directly from Atlas Corporation; 26,300 shares of Prudential Investors, Inc., common stock, of which 25,100 shares were acquired directly from Atlas Corporation and its subsidiaries; 10,000 shares of the capital stock of Ungerleider Financial Corporation, all of which were acquired from Atlas Corporation and its subsidiaries; 19,000 shares of the preferred stock of Federated Capital Corporation, all of which were acquired from Atlas Corporation itself; and 21,350 shares of the Class B common stock of Sterling Securities Corporation, of which 4,050 shares were acquired from Atlas Corporation.[88] All of these securities, with the exception of the Class B stock of Sterling Securities Corporation, were purchased by Iroquois Share Corporation at prevailing market prices.[89] In several cases the market prices of these securities were substantially less than their asset values.[90]

Minority stockholders of Iroquois Share Corporation were not informed of the fact that Atlas Corporation had changed the investment policy of their company to a program of acquiring investment company securities at less than their asset value, with the ultimate aim of realizing the actual asset values of the securities acquired by absorbing the assets of the investment companies involved.

On August 11, 1931, approximately four months after its acquisition of control of Iroquois Share Corporation, Atlas Corporation concluded its negotiations to acquire a controlling block of the stock of Chatham Phenix Allied Corporation at a cost of approximately $8,000,000. Atlas Corporation, however, did not then have in cash the entire amount necessary to purchase control of Chatham Phenix Allied Corporation. Accordingly, it borrowed $7,000,000 from Bankers Trust Company of New York.[91] As a step to repayment of this loan, Atlas Corporation, on the same day that it acquired control of Chatham Phenix Allied Corporation, caused its nominees on the directorate of Iroquois Share Corporation to sell, at their market value, virtually all of the corporate assets, which consisted essentially of the investment company securities which have already been described, to Chatham Phenix Allied Corporation, control of which was simultaneously being acquired by Atlas Corporation. Iroquois Share Corporation realized $1,155,528.75 in cash as the result of the sale. Immediately following the sale of the corporation's assets, the directorate of Iroquois Share

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[88] Op. cit. supra, note 72, Commission's Exhibit No. 2001.

[89] Ibid. The Sterling Securities Corporation Class B common stock had no quoted market value and no asset value. (Id., Commission's Exhibit No. 2001, p. 262.)

[90] This was true in the case of Federated Capital Corporation's preferred stock (see supra, p. 1289) and the capital stock of Ungerleider Financial Corporation (ibid.).

[91] See supra, pp. 1149–51.

Corporation resolved to dissolve the corporation and to hold a stockholders' meeting on August 29, 1931, to pass on the resolution. The result of the stockholders' meeting was a foregone conclusion, since Atlas Corporation owned in excess of 95% of the stock of Iroquois Share Corporation. In fact, on the very day that the directors adopted the resolution to dissolve, Atlas Corporation was advanced $1,200,000 in cash by Iroquois Share Corporation as a payment against the distributive share of the corporate assets to which Atlas Corporation would be entitled on the dissolution of the corporation. This cash advance to Atlas Corporation was almost exclusively derived from the sale by Iroquois Share Corporation of its assets to Chatham Phenix Allied Corporation. Atlas Corporation used the cash to repay, in part, its loan of $7,000,000 from Bankers Trust Company.[92]

Obviously the dissolution of Iroquois Share Corporation was a reflection only of the will of Atlas Corporation, apparently motivated primarily by its need for funds to effectuate its acquisition of control of another investment company. However, from the point of view of the minority stockholders of Iroquois Share Corporation, no compelling reason for the dissolution of the company existed, although the dissolution may have been advantageous to Atlas Corporation since it eliminated the expense of further operation of Iroquois Share Corporation as a separate corporate entity. Iroquois Share Corporation, although it had sustained large losses, was not insolvent, and its continued operation under the management of Atlas Corporation might have resulted in the eventual recoupment of the losses suffered by the corporation and its stockholders. In fact, as has been described, Atlas Corporation had caused Iroquois Share Corporation to purchase, at market prices which were in several cases substantially less than their asset values, securities of investment companies whose eventual absorption, with its attendant profits, Atlas Corporation was seeking to accomplish. Had Atlas Corporation permitted Iroquois Share Corporation to function until the dissolution by Atlas Corporation of the investment companies whose securities it had placed in the portfolio of Iroquois Share Corporation, the minority stockholders might have shared in any profit which Atlas Corporation may have derived as the result of its program of investment company acquisitions. Instead, Atlas Corporation, by dissolving Iroquois Share Corporation in a period of falling securities prices, eliminated the minority stockholders of Iroquois Share Corporation from the possible future benefits of the new investment policy of Iroquois Share Corporation. Nor did Atlas Corporation offer to the minority stockholders of Iroquois Share Corporation an opportunity to participate indirectly in its program by granting to such stockholders, as was done in the case of other companies dissolved by Atlas Corporation,[93] an option to receive either portfolio securities or cash as their distributive share of the corporate assets. By conveying the assets of Iroquois Share Corporation to Chatham Phenix Allied Corporation, which Atlas Corporation controlled, and substantially all of whose securities it eventually acquired,[94] Atlas Corporation in effect retained for its own stockholders all of the potential profits to be derived

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[92] Op. cit. supra, note 72, Commission's Exhibit No. 2001. Also, see supra, pp. 1149–53.
[93] See this section, infra, pp. 1446–53.
[94] See supra, pp. 1148–57.

from the investment of the funds of Iroquois Share Corporation, including those of its minority stockholders, in the securities of investment companies eventually absorbed by Atlas Corporation.

On the dissolution of Iroquois Share Corporation, its minority stockholders received a liquidating dividend of $8.35 a share of their stock.[95] The minority stockholders of Iroquois Share Corporation who had originally subscribed for their shares at a price of $21.50 a share thus suffered a loss of $13.15 a share on their investment in Iroquois Share Corporation,[96] virtually none of which loss, however, is attributable to the Atlas Corporation management.

b. Dissolution of Leverage Companies

(1) INABILITY OF PREFERRED STOCKHOLDER TO COMPEL DISSOLUTION

Elsewhere in this report[97] there is indicated the potentialities for abuse inherent in the conflicts of interest engendered by the capital structures of leverage investment companies; that is, companies which have outstanding, in addition to common stock, one or more classes of preferred stock or bonds or both. In essence, the common stockholder of a leverage investment company is trading with the funds of the senior security holders for his own account and for the purpose of augmenting the value of his own stock. As a quid pro quo for this ability to trade with the funds of senior security holders, the funds contributed to the enterprise by the common stockholder form a "cushion" or protection against a decline in the value of the corporate assets below the amount of the preferential claims of the senior security holders. In many cases, however, at least a majority of the common stock of leverage investment companies has been initially acquired by the sponsors or promotors for only a nominal consideration.[98]

On the other hand, the preferred stockholder (or the bondholder) has bargained for a fixed participation in the corporate earnings and for a preferential and fixed claim against the corporate assets on its dissolution. In reality, however, the protection apparently provided by the preferential claim of the senior security holder has been illusory. In the construction of a leverage capitalization, the majority voting power is always vested in the common stocks and since a dissolution of a corporation in most states requires the consent of the holders of two-thirds of the voting securities,[99] the preferred stock-

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[95] Op. cit. supra, note 72, Commission's Exhibit No. 2033. If the portfolio of Iroquois Share Corporation at the date that control was acquired by Atlas Corporation had been retained to the date that the corporation was dissolved, the per share liquidating value of the stock of Iroquois Share Corporation would have been $8.42 (ibid.).

[96] Public Examination, Iroquois Share Corporation, at 13939, and Commission's Exhibit No. 1422.

[97] See Ch. V of this part of the report.

[98] Compare the case of Sterling Securities Corporation, supra, pp. 1162–79.

[99] See this section, supra, p. 1429. In some states, either by judicial decision or by statute, minority stockholders may sue for a dissolution of a corporation when its objects are no longer capable of achievement, the management has been guilty of repeated acts of fraud or gross mismanagement, or the dissolution of the corporation will be "just and equitable." However, the petitioning stockholder has the burden of proving these conditions, a difficulty which may be insuperable in view of the financial expense which will be required

holders alone are never in a position to compel a dissolution of their corporation. The preferential right of the preferred stockholders are most important to them at a time when the corporate assets have declined to a point below the total sum to which they would be entitled on a dissolution of the corporation. In this situation, however, a dissolution of the corporation would conflict sharply with the interests of the common stockholders who would suffer a total loss both of their entire investment in the enterprise and of the opportunity to recoup their losses by virtue of the leverage potentialities in their shares in the event of a future appreciation in the value of the corporation's portfolio of securities. Rather than dissolve their corporation in the interests of the preferred stockholders, the tendency may be for the majority common stockholders to transfer their shares to others who are willing to pay attractive prices for control of the preferred stockholders' money.

The testimony of Carroll E. Gray, Jr., an officer of Burr & Co., Inc., a New York brokerage firm, and a former director and president of Burco, Inc., an investment company, graphically describes the illusory character of the preferences to which the preferred stockholder of an investment company is theoretically entitled on a dissolution of his company. In June 1932 Mr. Gray and certain of his associates had acquired at cost of $140,000 approximately 40% of the common stock of Burco, Inc., an investment company which had outstanding approximately 30,000 shares of preferred stock entitled on any dissolution of the corporation to a first claim against the corporate assets to the extent of $50 a share and accrued dividends. On February 28, 1938 Mr. Gray and his associates disposed of their common stock holdings in Burco, Inc., to a group headed by S. Leo Solomont, Thomas W. Morris, and Ralph H. Robb, Boston attorneys, for a total consideration of $340,000, or approximately $9 a share of their holdings. The then market value of the stock ranged from $1 to $1.50 a share in an inactive market. The common shares had no asset value since the approximate $1,250,000 of assets owned by the company were insufficient to cover the prior claim of the preferred stockholders if the corporation were then liquidated. This shift in the control of Burco, Inc., was consummated by Mr. Gray and his associates without previously informing or consulting with the preferred stockholders, the equitable owners of Burco, Inc.'s assets.[100] The new management derived the funds used to pay for the Burco, Inc., stock held by Mr. Gray and his associates by the sale of a substantial portion of the marketable securities in Burco, Inc.'s portfolio. The preferred stockholder's assets were thus used by the new management to acquire control of the corporation. As a result of this and other transactions between the corporation and the new management, approximately one-half of the value of Burco, Inc.'s assets, all of which in theory belonged to the preferred stockholders, was dissipated.[101] The impotency of the preferred stockholders to compel a dissolution of the corporation and the distribution of the corporate funds to them-

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to establish the facts and the general reluctance of the courts to dissolve a corporation where the majority voting stockholders desire its continuance. See Hornstein, *A Remedy for Corporate Abuse—Judicial Power to Wind Up a Corporation at the Suit of a Minority Stockholder,* 40 Columbia Law Review, 220 et seq. (1940).

[100] See supra, p. 1077, and Ch. II of this part of the report, pp. 350–496.

[101] Ibid.

selves, as an alternative to a shift in control of their assets to unscrupulous individuals, was pointed out by Mr. Gray in his testimony as follows: [102]

Q. So during the normal course of the history of the corporation or the investment trust, if they have enough money to cover the preferred and have something for the common, then this preference does not mean anything. The only thing the preference means is that he is getting less income than the common stockholders?

A. That is correct.

Q. The time that his preferred position is vital is when there is not enough money to pay common stockholders anything; the preferred stockholder becomes concerned then as to whether his preference is going to mean anything; is not that so?

A. That is correct.

Q. That was the situation at the time you carried on the negotiations for the sale of your common stock; is not that so?

A. Correct.

Q. The common stock, theoretically, if there was a liquidation had no value at all and here was the fellow who had the preferred stock who was sitting with his preferred stock, taking, shall I say, less income than the common stock. * * * always saying to himself, I may be making less than the common-stock holders, but when the judgment day comes and there is not enough money to pay the common stocks and preferred stocks, then at least I am going to get my principal back; is not that so?

A. Correct.

* * * * * * *

Q. You do not deny that at that time if there was a liquidation he would get every dollar of the money?

A. That is correct.

Q. And the common stockholder would get nothing?

A. That is correct.

Q. * * * what percentage did you say that was again, your block?

A. 40 percent.

Q. Almost a majority of the stock, less 10 percent, had it in their power to either consent to the liquidation or not consent to the liquidation. * * * is not that so?

A. That is correct.

Q. You do not deny, Mr. Gray, that if you decided that you thought the trust should be liquidated at that time that you with your block of stock could have had that trust liquidated and turned the assets over to the preferred?

A. I did not think it should be liquidated at that time or at any other time.

Q. I am not saying that. I am just propounding the hypothetical question. Your block of stock would have played a material part in any attempt to liquidate; is not that so?

A. That is correct.

* * * * * * *

Q. When you sat there with the common stock and the public was in the preferred stock and the balance of the common—I am just addressing myself to the preferred stockholders; I just want to find out what a preferred stock really is, and from its theoretical attributes—the effect of that is that you were speculating with the public money; is that not so?

A. In what manner?

[102] Public Examination, First Income Trading Corporation, et al., at 873–6.

Q. Well in this manner: When you * * * analyze what the preferred stock really is and try to analogize to a margin account, the preferred stock is really in the position of a broker in that he is putting up the fund with which the common stockholder speculates, is not that so?

A. That is so in any business.

Q. I am not unmindful of that.

A. Your premise is correct.

Q. That is right, so that capital structure which has senior securities in it is nothing more or less than a margin account for the common stockholder, is not that so?

A. No; I would not put it in those terms. * * * I will say the preferred stockholder put his money in any corporation with the knowledge the common stockholder is going to manage the corporation.

Q. Well no, but I am not talking about managing the corporation. The preferred stockholder puts up the money, is not that so?

A. Correct.

Q. He has got a ceiling on what his return can be * * * no matter what the assets of the company are?

A. That is correct.

Q. He cannot get more than a fixed percentage of the income, is not that so?

A. That is correct.

Q. That is similar to a broker putting up margin for an account of his. The only thing he can get is his money back.

A. Yes.

Q. And his interest on the amount of money he loans to the customer, is not that so?

A. Yes.

Q. So, the money contributed by the preferred stockholder in that respect, I say, was like the margin supplied by a brokerage firm to a fellow who is going to trade in common stock, is not that so? That is what you are doing?

A. No; I do not think so. * * *

Q. Well, if anything, the analogy is stronger because if that was a margin account when your account was under water, you would have gotten a telephone call to put up more margin.

A. That is correct.

Q. But in this case you did not even have to put up more money even though preferred stock was under water, is that so?

A. Correct.

As a result, therefore, of the conflicts of interest which are inherent in a leverage capital structure, preferred stockholders are normally incapable of protecting their interests by a dissolution of their company.

On the other hand, the refusal of the sponsor common stockholders to permit a liquidation in the interests of the preferred stockholders is sometimes justified on the ground that the investment of the minority common stockholders in the enterprise would be wiped out if the corporation were liquidated at a time when the common stock had no asset value. Nevertheless, the sale of control by the majority common stockholders may only postpone the dissolution of the corporation and its attendant eradication of the investment of minority common stockholders.

(2) DISSOLUTION WHEN COMMON STOCK IS WITHOUT ASSET VALUE

Where a majority control of both preferred and common stock of a leverage investment company has become concentrated in the hands of one individual or organization, a dissolution which will wipe out the investment of minority common stockholders may occur. The legal inability of the preferred stockholders alone to compel a dissolution of their corporation is the cornerstone of campaigns to acquire such preferred stock at market prices which are substantially less than their actual value and to realize the real value of the stock by the ultimate absorption of the corporation's assets by effecting its dissolution. In the course of such campaigns the percentage of common stock required to dissolve the corporation is acquired not for its inherent value but for its value as an implement to effect legally a liquidation of the corporation. The asset losses involved in the acquisition of the negative asset value common stock are to be retrieved by the profits on the acquisition of preferred stocks. Essentially, the interest of the dominant stockholder is in its preferred stock holdings. Its position may be, therefore, antagonistic to that of minority common stockholders.

When acquisition of the preferred stock by the dominant holder of all classes of stock has reached its maximum, a dissolution of the corporation may be effected by such stockholder at a time when the minority common stock has no asset value. The possible inequity to the minority common stockholder of a leverage investment company of dissolving the company in such circumstances may be gleaned from the testimony of Floyd B. Odlum, president of Atlas Corporation. As has already been described, in September 1931 Atlas Corporation contracted to purchase at a price of $3 a share approximately two-thirds of the negative asset value common stock of National Securities Investment Company, a leverage company, from A. G. Becker & Co., the company's sponsor. Mr. Odlum justified the sale by A. G. Becker & Co. of its common stock to Atlas Corporation on the ground that a dissolution of the company in the interest of the preferred stockholders of National Securities Investment Company, who had originally purchased their shares from A. G. Becker & Co., the underwriter of the stock, would have been unfair to the company's minority common stockholders: [103]

Q. The preferred stockholder says: "I want the assurance of the return of my principal and in order to get that assurance I am willing to take a smaller return, while you, Mr. Common Stockholder, are willing to gamble with respect to the return of your principal, and, therefore, in consideration of that you are entitled to a higher return if it is made." Isn't that so?

A. No. That is not what the preferred stockholder said. The preferred stockholder, if he wanted to have an assurance of the return of his principal, would not have bought a preferred stock of an investment trust.

Q. He would have put it in the bank?

A. Yes. He would have put it in the bank. He said, "I want to be assured that I have a cushion behind me and that I will get whatever is there, up to my principal, before the fellow who is junior to me gets anything. For putting that cushion behind me I will limit my profits."

[103] Op. cit. supra, note 72, at 18069–71.

Q. Then he says, "If the time comes when this trust is to be liquidated, I am to get a first lien on the assets."

A. Everything that is there until I am paid.

Q. And in this case the one who is substantially preventing him from getting the first lien on the assets was A. G. Becker because they had the common stock control.

A. You raise a question there. If you are talking of a one-stock [i. e., non-leverage] company, I can go a long way with you. When you are talking of the company with preferred and common, where the common has put in real money and has protected the preferred all of the way down in a falling market and no liquidation was originally contemplated, I think there is a very grave question and I would be inclined to resolve it in favor of the continuity of the company, and you should not pick the low spot where you would wipe out the man junior to you and try to force a liquidation. Furthermore, if Becker had ever agreed with what you are saying he would have exercised his right as controlling common stockholder to wipe out the minority [common] stock which was in the hands of the public.

In September 1931, when Atlas Corporation agreed to purchase A. G. Becker & Co.'s holdings of the common stock of National Securities Investment Company, that company's preferred stock, which was entitled on dissolution of the company to a first claim against the assets to the extent of $100 a share plus accrued unpaid dividends, had a per share asset value of $73.72.[104] By July 24, 1935, the asset value of the preferred stock of National Securities Investment Company had increased to $96.25 a share[105]—a performance superior to that of the Standard Statistics Company's 90 common stock index for the same period.[106] The common shares of the company were still without asset value.[107]

Meanwhile, however, Atlas Corporation had, as a result of its cash purchases and exchange offers, acquired 97% of National Securities Investment Company's preferred stock and 92% of its common stock.[108] And, as has been pointed out elsewhere in this chapter,[109] Atlas Corporation had acquired its preferred stock in National Securities Investment Company at a substantial discount from its asset value.

On July 24, 1935, Atlas Corporation, as the holder of in excess of two-thirds of the voting securities of National Securities Investment Company, caused that company to be dissolved. Minority stockholders owning 73,448 shares of the common stock of National Securities Investment Company who had refused to sell their shares or accept Atlas Corporation's exchange offers (possibly on the ground that they desired a continuance of their company and an opportunity to recover their losses), had no choice but to accept the dissolution of their company. They were deprived in the rising security markets of 1935 of the "leverage" supplied to their common stock by the preferred stock of their company, 97% of which was owned by Atlas Corporation. However, Atlas Corporation

[104] See supra, pp. 1111–12.

[105] Op. cit. supra, note 72, Commission's Exhibit No. 2001 (p. 191).

[106] Id., Commission's Exhibit No. 2033.

[107] Id., Commission's Exhibit No. 2001 (p. 191).

[108] Ibid.

[109] See supra, pp. 1111–19.

voluntarily paid the sum of $1.50 a share to the minority common stockholders of National Securities Investment Company when the common stock was without asset value, out of Atlas Corporation's distributive share of the assets of National Securities Investment Company.[110] Mr. Odlum testified:[111]

A. We did not feel it [National Securities Investment Company] could be dissolved when the common stock was below asset value, without wiping out the minority common stock group, and we paid it out of our pocket to get it dissolved.

Q. The company was kept alive. But when for the beneficial purpose of Atlas Corporation they thought that was the time to dissolve National Securities Investment Company, they dissolved it and paid $1.50 a share to the minority common stockholders. Isn't that so?

A. We dissolved the trust as soon as we could. If we had waited for the market to carry through we didn't know when it would be. But don't forget at the time the stock was bought at $3 a share (from A. G. Becker & Co.) and until we paid $1.50 per share the market had also changed. The market on investment trust stocks went down as low as 50 and 25.

Q. What happened to the good old leverage?

A. It was working the other way.

Q. About the time it was supposed to come back * * * and work in the common stock's favor, the company was dissolved?

A. One never knows what the future will bring.

Q. I am glad to hear you say that.

A. I don't know, anyway.

Minority common stockholders of Federated Capital Corporation, another leverage company, control of which was acquired by Atlas Corporation, were similarly eliminated from any continuance of their interest in their company by its dissolution on July 25, 1935.[112] The common stock of Federated Capital Corporation had been entirely sold to the public from 1927 to 1930, and of the approximately $6,400,000 of capital raised by the company, approximately $2,800,000 represented the contribution to the enterprise made by common stockholders;[113] the remainder of the capital was contributed by holders of the company's preferred stock which on dissolution of the company was entitled to a priority in assets to the extent of $26.25 a share and accrued dividends.[114]

As has already been described,[115] Atlas Corporation acquired control of Federated Capital Corporation, not by the purchase of a majority block of the securities of the corporation but by the assignment to it by the corporation's original sponsor of a contract to manage the corporation. Atlas Corporation, with the paid assistance of P. H. Whiting & Co., Inc.,[116] the original distributor of Federated Capital Corporation's securities, then began to acquire by purchase or exchange offer of its own shares, the securities of Federated Capital Corporation, particularly the preferred stock, which

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[110] Op. cit. supra, note 72, Commission's Exhibit No. 2001.

[111] Id., at 18017–8.

[112] Id., Commission's Exhibit No. 2001 (p. 242).

[113] Public Examination, Federated Capital Corporation, Commission's Exhibit No. 1476.

[114] Id., Commission's Exhibit No. 1471 (p. 11).

[115] See supra, pp. 1278–93.

[116] Ibid.

from 1931 to 1935 had an asset value substantially greater than its market price.[117] The common stock, which over the same period had a negative asset value, was acquired by Atlas Corporation only because of its utility as the legal tool for the effectuation of the ultimate dissolution of the corporation. By July 25, 1935, Atlas Corporation had acquired 94.2% of the preferred stock of Federated Capital Corporation and 68.6% of its common stock.[118]

From May 1931 to July 25, 1935, the asset value of the preferred stock of Federated Capital Corporation had increased from $24.48 a share to $25.25 a share, a performance substantially better than that of the Standard Statistics Company's 90 common stock index for the period.[119] Although the common stock of Federated Capital Corporation had, from 1931 to July 25, 1935, a small negative asset value, the demonstrated management ability of Atlas Corporation and the prospect, in the middle of 1935, of a continued rise in security values combined with the leverage advantage in the common stock of Federated Capital Corporation, seemed to indicate that, in the near future, such stock would acquire a substantial asset value.

Although the public held 32% of the common stock of Federated Capital Corporation, Atlas Corporation, on July 25, 1935, as the majority holder of all classes of Federated Capital Corporation's securities, voted to dissolve the company. Atlas Corporation, however, out of its own distributive share of the assets of Federated Capital Corporation, paid to minority stockholders $1.25 for each share of their common stock—a sum in excess of the then market value of such stock. As has been pointed out, the common stock of Federated Capital Corporation would have been entitled to none of the assets of Federated Capital Corporation.[120]

Nevertheless, the minority common stockholders had no choice but to accept the $1.25 a share. Holders of approximately 14,000 shares of the total minority interest of 77,000 common shares, headed by V. A. Sears, a Boston security dealer who had been one of the original distributors of the common stock of Federated Capital Corporation,[121] opposed the dissolution of the corporation. At the stockholders' meeting called to approve the dissolution of the corporation, a motion made by Mr. Sears, supported by the holders of 14,000 shares of minority common stock, to postpone dissolution of the corporation for a period of two years, presumably in the hope that, after such period an improvement in market values of securities supplemented by the "leverage" in the common stock would increase the asset value of such stock to an amount in excess of the $1.25 a share offered by Atlas Corporation, was voted down by the proxies of Atlas Corporation. The attitude of the minority common stockholders is indicated in a statement made at the stockholders' meeting by Fred G. Perkins, one of such stockholders: [122]

* * * I wish to lodge a protest against the dissolution of Federated Capital Corporation, a proposal manifestly motivated at least by those directors, being a majority closely identified in interest or association with Atlas Cor-

[117] Ibid.

[118] Op. cit. supra, note 72, Commission's Exhibit No. 2001.

[119] Id., Commission's Exhibit No. 2033.

[120] Id., Commission's Exhibit No. 2001 (p. 242).

[121] Op. cit. supra, note 113, at 14531–2.

[122] Id., Commission's Exhibit No. 1494.

poration * * *. No one doubts, if the controlling corporation wills this dissolution to take place, that such will eventuate, and this with seeming right of law and the minority of stockholders of the controlled corporation to the contrary notwithstanding. * * * This situation is not cured by an offer, from any source of more than the market value of the corporation's shares in view of the very nature of the shares and their potentialities in future.

Atlas Corporation, as has been indicated, compensated the minority common stockholders because it dissolved its controlled leverage companies at a time when such common stock had no asset value. Nevertheless, both the time of dissolution and the amount of compensation, if any, to be paid minority interests who would suffer by the dissolution, rests solely in the discretion of the dominant stockholder. No legal requirement compels the compensation of minority interests whose investment in the enterprise may be eradicated by a dissolution. In fact, The Equity Corporation dissolved three of its controlled leverage investment companies, Yosemite Holding Corporation, Eastern Shares Corporation, and Allied General Corporation, at a time when their common shares had no asset value, and when the outstanding minority common interest in the stock of these companies was 3.7%, 1.2%, and 8.6%, respectively.[123] No compensation was extended by The Equity Corporation to these minority common stockholders.

2. MANAGEMENT EVALUATION OF ASSETS ON DISSOLUTION

The evaluation, for distributive purposes, of the assets of dissolving investment companies is almost completely within the control of the directors of such corporations. Ordinarily the state laws entrust to the directors of an investment company the entire control over its dissolution, and the distribution of its assets to the stockholders. Such activities of the directors ordinarily are subject to no supervision or surveillance by any administrative or judicial body.[124] Where the directors are the mere nominees of a majority stockholder, they naturally would be desirous of obtaining the assets of the corporation at a valuation which will result in the least possible distribution of the corporate assets to minority stockholders. The absolute discretion of such directors to determine the procedure by which the corporate assets are to be liquidated may result in oppression of minority stockholders.

Ordinarily an investment company's assets consist of readily marketable securities and cash. On dissolution the distributive share of each stockholder in the total assets is determined by the market prices of the securities in the portfolio on their sale on the securities exchanges or privately. Nevertheless, as the Commission has stated elsewhere:[125]

Market prices vary from day to day. There is room for the exercise of judgment as to the dates when the prices will range the highest, and when they will range the lowest. A management interested in obtaining the assets for a lower

[123] Op. cit. supra, note 73, Commission's Exhibits Nos. 843, 1183.

[124] See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, pp. 302–3.

[125] Id., p. 297.

cost might select one day for one sale; a management interested in a sale to realize as much as possible for the company, might select another.

However, where the assets are not readily marketable or where market valuations of the portfolio securities are not an accurate reflection of their real value, the opportunity to exploit minority stockholders is accentuated. In such cases the liquidation of the nonmarketable securities in the dissolving company's portfolio may be accomplished by an auction sale. And the terms of the sale may be devised to assure the purchase of the assets by the dominant stockholders.

a. Dissolution of Yosemite Holding Corporation by The Equity Corporation

The dissolution, in January 1934, of Yosemite Holding Corporation, then 95% controlled by The Equity Corporation, is illustrative of the potentialities of abuse to minority stockholders inherent in the ability of the majority stockholder, through its control of its subsidiary's directorate, to determine the method of liquidation of its non-marketable assets.

On January 29, 1934, the board of directors of Yosemite Holding Corporation voted to sell at public auction the bulk of the company's assets.[126] The greater part of these assets consisted of holdings of approximately 52% of the outstanding common stock of Chain & General Equities, Inc.[127] The stock was bid in by The Equity Corporation for $215,000.[128] This sum virtually determined the pro rata distribution that the minority stockholders of Yosemite Holding Corporation received as a liquidating dividend. But the terms and conditions upon which the public auction was held were so fixed by The Equity Corporation controlled board of directors of Yosemite Holding Corporation that any bid other than that of The Equity Corporation would have been unlikely. It was required that a certified check of $100,000, or cash in that amount, be deposited to qualify anyone as a bidder. Thus, W. F. Best, the treasurer of The Equity Corporation, testified:[129]

A. * * * The terms of the auction were that a certified check—the one that I am recalling that I was at—the terms, I think, were in order to bid at all a certified check of $100,000 or cash, must be deposited with the auctioneer.

Q. These terms weren't fixed by law?

A. No, no; they were fixed by the Yosemite Corporation.

Q. That means fixed by The Equity Corporation because it controlled Yosemite.

A. That is right. It was fixed by the Directors of the Yosemite. I don't recall whether they were entirely interlocking or not.

The justification asserted by Mr. Best for this requirement was: "It was done for the purpose of establishing bona fide bidders. Anybody who was bona fide and really wanted that stuff and showed

[126] Derived from supplementary information supplied the Commission for Yosemite Holding Corporation (minutes of board of directors meeting of January 29, 1934).

[127] Op. cit. supra, note 73, Commission's Exhibit No. 843.

[128] Id., at 10742.

[129] Id., at 12138.

their ability to put up the money, why all right, we were willing to consider him a bidder."[130] It is apparent, however, that the requirement might also serve to discourage other bidding from bona fide prospective bidders who were not prepared to meet the condition. Thus, Mr. Best testified:[131]

Q. In all these sales that you had, was there ever anybody who made a competitive bid at more than the price bid by The Equity Corporation?

A. I don't recall being at more than this one. At that auction there were several people that talked to the auctioneer but when he read the terms that required a deposit of $100,000 cash, or a certified check, they did not bid.

On the other hand, The Equity Corporation was in a peculiarly advantageous position to make any bid requiring a substantial cash outlay. By virtue of its holdings of over 90% of the preferred stock of Yosemite Holding Corporation,[132] money advanced by it in payment of its bid would be returned almost immediately in the form of a pro rata distribution of the corporation's assets. Mr. Best testified:[133]

Q. But under the facts which existed at the time of this sale, The Equity Corporation had virtually all of the preferred stock, that is over 90 percent, so that its cash would come right back to it, automatically, merely by the fact of the sale and distribution of assets.

A. Of course it is perfectly true, on the dissolution of that particular corporation Equity would have gotten its pro rata share of the cash value.

Q. Which would mean substantially over 90 percent?

A. Whatever stock that it held.

In any event, the net result was that The Equity Corporation's bid was the only one made, and that bid was the amount at which the assets were sold. Mr. Best testified:[134]

Q. So that regardless of the reasons for it, the fact of the matter is that The Equity Corporation made the only bid that was made?

A. Equity made the only bid.

Q. So that the price that Equity fixed, as the value of those assets, was accepted as the price at which those assets were sold?

A. That is correct.

It was in this manner that The Equity Corporation determined the price which would be paid for the assets of the corporation being liquidated. This amount in turn determined the sum to be received by the minority stockholders who did not accept the exchange offers. As Mr. Best testified, The Equity Corporation officers "got together and determined what they thought was a fair price that Equity was willing to pay for them."[135] He agreed that the only protection the minority stockholders had was the conscience of The Equity Corporation controlled management of Yosemite Holding Corporation:[136]

Q. * * * And the only safeguard which these minority stockholders had with respect to the fairness of the bid price was the conscience of the officers of The Equity Corporation?

[130] Ibid.
[131] Id., at 12151.
[132] Id., Commission's Exhibit No. 1183.
[133] Id., at 12134–7.
[134] Id., at 12138–9.
[135] Id., at 12140.
[136] Id., at 12142–3

A. Was the conscience of the officers of the Yosemite or dissolving corporation. They could have refused the bid.

Q. All right, and those officers were controlled by The Equity Corporation, is not that so?

A. It just happens in Yosemite that I don't think they were.

Q. But we have—the record is replete with testimony that there was——

A. Yes, there was; that is true.

But, as has already been stated, The Equity Corporation interests were squarely opposed to the interests of the minority stockholders. This is strikingly shown by the testimony of Mr. Best:[137]

Q. Now, you have stated that The Equity Corporation officers would sit down and decide what they thought would be a fair price.

A. That is correct.

Q. You also stated that you, as an Equity Corporation officer and as an officer also of the Yosemite Holding Corporation, might have used a different basis of arriving at a fair price than they did?

A. That is correct.

Q. And so any number of other people might have used a different basis of determining what would be a fair price than the Equity Officers had used? * * *

A. That is true.

Q. And, as a matter of fact, what the Equity officers determined to be a fair price was the one that was accepted as a fair price, by virtue of their dominant position in the situation?

A. By virtue that nobody else bid.

* * * * * * *

Q. As a matter of fact, The Equity Corporation had an interest in the situation which would require them to purchase the assets at as low a price as possible * * *.

In other words, if The Equity Corporation put up money to purchase the assets of this corporation, a portion of that money would go to the minority stockholders who didn't come into the situation during the exchange program. Isn't that so?

A. On dissolution they would get that; yes.

Q. Now, the higher the bid the more those stockholders would get.

A. That is true.

* * * * * * *

Q. When you have this situation with the parent and the subsidiary company in circumstances where there is to be a public auction upon the dissolution, there might be an element of conflict, might there not, Mr. Best, by virtue of the fact that as an officer of The Equity Corporation you are duty bound to buy the assets at the cheapest price, and as an officer and director of the underlying corporation you are bound to see that the stockholders get the highest price possible?

A. Yes; there is clearly a double liability.

R. S. Elliot, the secretary of The Equity Corporation, was prepared to say that the situation was one which "the majority must look at * * * fairly carefully" to determine "that they are making a fair offer."[138] Realistically, the minority stockholders were completely in the hands of The Equity Corporation as the dominant interest,

[137] Id., at 12146–8. 12154.

[138] Id.. at 10748.

for any improvement in their position could come only at The Equity Corporation's expense.

b. Dissolution of Companies Controlled by Atlas Corporation

As has been indicated elsewhere in this chapter, Atlas Corporation dissolved the majority of its controlled companies; three subsidiaries were dissolved in 1931, eight in 1933, and three in 1935.[139] Prior to its dissolution of these companies, Atlas Corporation had in many instances caused them to purchase in the market or from Atlas Corporation and its affiliated companies[140] substantial blocks of the securities of other Atlas Corporation controlled investment companies. The asset value of most of these securities substantially exceeded their market value. On the date of their dissolution, therefore, the portfolios of many of Atlas Corporation's subsidiaries contained varying blocks of the securities of as yet undissolved subsidiaries. For example, all the subsidiaries which were dissolved in 1933 and two of three subsidiaries which were dissolved in 1935 held the securities of one or more of other Atlas Corporation controlled investment companies which were dissolved, sold, or consolidated with Atlas Corporation at a later date. The companies later absorbed were National Securities Investment Company, American Investors, Inc., and Federated Capital Corporation, all of which were dissolved in 1935,[141] and Pacific Eastern Corporation, Shenandoah Corporation, and Sterling Securities Corporation, which were consolidated with Atlas Corporation in October 1936.[142] American, British & Continental Corporation and Blue Ridge Corporation were sold by Atlas Corporation in 1935.

Both in 1933 and in 1935 these investment companies whose securities were in the portfolios of other subsidiaries which were dissolved in 1933 and 1935, were controlled by Atlas Corporation. The following figures[143] indicate the control of these companies held by Atlas Corporation at December 31, 1933, and at December 31, 1935, or at the date of the prior sale or liquidation of the company:

Name of company	Percentage controlled by Atlas Corporation					
	Dec. 31, 1933			Dec. 31, 1935, or prior date of dissolution		
	Bonds	Preferred	Common	Bonds	Preferred	Common
Federated Capital Corporation		91	62		94	69
National Securities Investment Co		88	84		97	92
American Investors, Inc		59	75		73	83
Pacific Eastern Corporation			64			73
Sterling Securities Corporation		63 pfd. 26 pfce.	83 Cl. B. 29 Cl. A.		75 pfd. 62 pfce.	88 Cl. B. 46 Cl. A.
Shenandoah Corporation		71	57		85	96
Blue Ridge Corporation		23	87.8		23	87.9
American, British & Continental Corporation	46	53	68	49	64	77

[139] See supra, pp. 1064–5.

[140] Op. cit. supra, note 72, Commission's Exhibit No. 2001.

[141] Ibid. and id., Commission's Exhibit No. 1958.

[142] Id., Commission's Exhibit No. 1958.

[143] The figures used in this table are derived from id., Commission's Exhibit No. 2001.

The preferred stocks and bonds of these companies, throughout the entire period of their control by Atlas Corporation, sold in the market at prices substantially less than their asset values. The common stock of these companies, with the exception of that of American Investors, Inc. and Pacific Eastern Corporation, sold in the market at technical premiums since they had no asset value, in fact had negative asset values.

Whether to evaluate for distributive purposes the assets of those of its dissolved companies which contained the securities of other controlled investment companies, at their market values, asset values, or on any other basis, was solely in the discretion of Atlas Corporation. Table 20 [144] indicates the substantial variation in the distributive shares of the minority stockholders in the companies dissolved by Atlas Corporation in 1933 and 1935, depending on whether the securities of the other Atlas Corporation controlled companies in the dissolved companies' portfolios [145] were valued at their market or asset values: [146]

TABLE 20.—*Minority interest in investment companies dissolved by Atlas Corporation in 1933 and 1935, on the basis of both the market and asset value of portfolio holdings of investment companies in the Atlas group*

Name of dissolved company	Date of dissolution	Total shares outstanding		Net worth on basis of market value of assets in portfolios	
		Preferred shares	Common shares	Total	Per share
Allied Atlas Corporation	June 6, 1933		288, 204	$4, 394, 353. 83	$15. 28
General Empire Corporation	June 21, 1933		201, 852	3, 869, 752. 00	19. 17
Aviation Securities Corporation	Nov. 3, 1933		134, 000	1, 998, 679. 74	14. 92
The Financial Corporation	Nov. 6, 1933		220, 755	5, 185, 830. 01	23. 49
Chain Store Stocks, Inc	Nov. 24, 1933		231, 791	2, 578, 629. 46	11. 32
Securities Allied Corporation	Dec. 8, 1933		1, 434, 057	21, 756, 664. 22	14. 72
All America General Corporation	Dec. 30, 1933		165, 600	2, 375, 827. 98	14. 35
Atlantic Securities Corporation	Dec. 30, 1933	50, 889	168, 250	2, 221, 444. 81	pfd. 43. 65
National Securities Investment Co	July 25, 1935	137, 782	929, 318½	12, 708, 946. 71	pfd. 92. 24
Federated Capital Corporation	July 27, 1935	122, 320	249, 999. 04	3, 127, 425. 03	pfd. 25. 57
Total				60, 315, 240. 04	

Source: See note 144 in text.

[144] The figures used in this table were derived from id., Commission's Exhibit No. 2001 and the replies to the Commission's questionnaire for the listed companies, Pts. II and III. The asset values of the securities of other investment companies controlled by Atlas Corporation and contained in the portfolios of the listed companies (see following footnote) were derived from the same sources.

[145] The securities of other surviving Atlas Corporation controlled investment companies contained in the portfolios of the dissolved investment companies listed in the table, were primarily those of National Securities Investment Company, American Investors, Inc., Federated Capital Corporation, American, British & Continental Corporation, Blue Ridge Corporation, Pacific Eastern Corporation, Shenandoah Corporation, and Sterling Securities Corporation. (Replies to the Commission's questionnaire for the investment companies listed in the table, Pt. III.)

[146] The figures in the table for the per share asset value of the securities of the listed companies based on the market values of their assets represent asset values at the date of the dissolution of the listed companies. Between the date of the dissolution of these companies and the final distribution of their assets, the market value of the portfolio

TABLE 20.—*Minority interest in investment companies dissolved by Atlas Corporation in 1933 and 1935, on the basis of both the market and asset value of portfolio holdings of investment companies in the Atlas group*—Continued

Name of dissolved company	Net worth on basis giving underlying asset values to securities of Atlas Corporation controlled companies in portfolios		Difference in net worth representing excess of underlying asset over market value basis		Minority interest at date dissolution			
					Preferred		Common	
	Total	Per share	Total	Per share	Shares	Percent of outstanding shares	Shares	Percent of outstanding shares
Allied Atlas Corporation	$4,652,203.83	$16.17	$257,850.00	$0.89			8,627½	3.00
General Empire Corporation	4,518,829.37	22.39	649,077.37	3.22			1,805	.89
Aviation Securities Corporation	2,351,871.51	17.55	353,191.77	2.63			2,870	2.15
The Financial Corporation	8,083,785.91	36.62	2,897,955.90	13.13			5,730	2.65
Chain Store Stocks, Inc.	3,278,656.96	15.77	1,056,099.05	4.58			11,586	5.00
Securities Allied Corporation	29,470,188.86	19.94	7,713,524.64	5.22			43,972	3.29
All America General Corporation	3,242,950.21	19.58	867,122.23	5.23			1,487	.90
Atlantic Securities Corporation	4,117,653.57	pfd. 58.75 com. 7.08	1,862,037.52	pfd. 13.18 com. 7.08	906	1.78	3,641	2.16
National Securities Investment Co	13,645,141.30	pfd. 99.03	936,194.59	pfd. 6.79	4,474	3.25	73,333	7.89
Federated Capital Corporation	3,361,528.66	pfd. 27.48	234,103.63	pfd. 1.91	6,687	5.61	77,014	30.81
Total	77,142,396.74		16,827,156.70					

Source: See note 144 in text.

To a substantial extent Atlas Corporation possessed the ability to realize the actual asset value of the investment company portfolio securities of these companies. As has already been indicated in schedule form, Atlas Corporation held directly or indirectly, both in 1933 and in 1935, in excess of two-thirds of the voting stocks of Federated Capital Corporation (in which both classes of stock had voting power), National Securities Investment Company, American Investors, Inc., and Blue Ridge Corporation—a voting strength sufficient to give Atlas Corporation alone the absolute power to effect their dissolution. Atlas Corporation held also blocks of the securities of

increased slightly in most cases, so that the actual liquidating dividends paid in cash to the minority stockholders of the listed companies were as follows: Allied Atlas Corporation, $15.58 a share; General Empire Corporation, $21.15 a share; Aviation Securities Corporation, $15.31 a share; The Financial Corporation, $30.76 a share; Chain Store Stocks, Inc., $11.32 a share; Securities Allied Corporation, $15.31 a share; All America General Corporation, $13.17 a share; Atlantic Securities Corporation, $58.75 a share of preferred stock and $3 a share of common stock (see supra, p. 1258); National Securities Investment Company, $96.25 a shares of preferred stock; and Federated Capital Corporation, $25.25 a share of preferred stock (op. cit. supra, note 72, Commission's Exhibit No. 2033). It will be recalled that Atlas Corporation voluntarily paid $1.50 to the minority holders of the common stock of National Securities Investment Company and $1.25 to the minority holders of the common stock of Federated Capital Corporation, although at the date of distribution these companies' common stocks had no asset value. (See supra, pp. 1438–42.)

Pacific Eastern Corporation, Sterling Securities Corporation (in which all shares had voting power and in which Atlas Corporation held 43% of all shares outstanding), Shenandoah Corporation, and American, British & Continental Corporation, sufficient in size to give Atlas Corporation for practical purposes, the power to dissolve, consolidate, or merge these companies with itself. The securities of these companies not dissolved in 1933 were included in the portfolios of the investment companies which Atlas Corporation dissolved in 1933 and 1935.

In the interest of the minority stockholders of the companies which were dissolved in 1933 and 1935, Atlas Corporation, as the dominant stockholder, might have made some attempt to dissolve its controlled investment companies which survived the year 1933, and whose securities were in the portfolios of the dissolved companies. If dissolution of such companies was impractical because of the illiquidity of the assets of such companies as Pacific Eastern Corporation, or inequitable because of the effect of a dissolution on minority common stockholders of these investment company subsidiaries whose common stocks had no asset value, then some effort might have been made by Atlas Corporation to consolidate or merge all of its controlled investment companies on a basis which would give effect to the inherent asset values of the various companies' securities. Such a procedure would have insured to minority holders of the securities of all its subsidiary companies, as well as to Atlas Corporation, the actual asset value of their respective interests. On the other hand, however, Atlas Corporation, by keeping alive its other controlled investment companies whose securities were in the portfolios of the subsidiaries which it dissolved in 1933 and 1935, could derive for itself additional profits by the continued purchase in the open market of the securities of such companies at prices representing discounts from their asset values. And the fact is that Atlas Corporation, between 1933 and 1935, substantially increased its holdings of such companies' securities.[147]

Atlas Corporation resolved this conflict between the interests of minority stockholders of its subsidiaries and its own pecuniary interests by dissolving the subsidiaries which have been listed above, in 1933 and in 1935. However, on dissolution, all stockholders in the dissolved companies were given the opportunity (which usually was required to be exercised within a period of approximately two weeks)[148] to obtain their distributive share of the corporate assets either in cash or in a pro rata distribution of the company's portfolio in kind. Atlas Corporation invariably elected to receive its distributive share of the corporate assets in portfolio securities in kind.[149] It was thus enabled to acquire portfolio securities whose asset values exceeded their market value.[150] Theoretically, minority stockholders occupied the same position. They could also elect to obtain their pro rata portion of the portfolio. However, the circular

[147] Op. cit. supra, note 72, Commission's Exhibit No. 2001.

[148] See, e. g., the letter addressed to the minority stockholders of General Empire Corporation (id., Commission's Exhibit No. 2037, Item 34–A). The letter was dated June 12, 1933, and stockholders were required to elect on or before June 29, 1933, whether or not they desired their distributive share of the assets of General Empire Corporation in cash or in portfolio securities.

[149] Id., Commission's Exhibit No. 2001.

[150] Ibid.

letters[151] containing the option given to minority stockholders to obtain their distributive share of the dissolved corporation's portfolio revealed neither the difference between the market and asset value of the securities of other Atlas Corporation controlled companies held by their company, nor the fact that Atlas Corporation was or would be shortly capable of realizing the asset value of the portfolio securities by dissolving or consolidating with itself the investment companies whose securities were in the portfolio of the dissolving companies. On the happening of either of these events, minority stockholders who received in kind the securities of these later dissolved or consolidated companies would, of course, achieve the same gain that accrued to Atlas Corporation. But, even if minority stockholders were aware of these facts, the time of dissolution or consolidation of the Atlas Corporation affiliates whose securities were in the portfolios of their dissolving companies, rested solely in the hands of Atlas Corporation. When Atlas Corporation would dissolve or consolidate these companies was uncertain. Even informed minority stockholders who were in need of cash might, therefore, waive their option to receive the securities in the portfolios of their companies in kind. The fact is that the great majority of the minority stockholders of the companies dissolved by Atlas Corporation elected to receive their distributive portion of the assets of their company in cash.[152]

In determining the cash value of the distributive shares of minority stockholders of the investment companies dissolved by Atlas Corporation in 1933 and 1935, with few exceptions, the market values of the securities of surviving Atlas Corporation controlled companies in their portfolios were used. To obtain the cash required for liquidating dividends, portfolio securities, including those of Atlas Corporation controlled companies, were sold to Atlas Corporation and its surviving affiliates at their market value.[153] With respect to the use of market values for this purpose, first, the character of the market for investment company securities in 1933 militated against the use of market values as a sole criterion of actual value;[154] second, the paucity of the floating supply of the securities of Atlas Corporation's

[151] See, e. g., the letter addressed to minority stockholders of General Empire Corporation (id., Commission's Exhibit No. 2037, Item 34–A).

[152] See, e. g., the case of Securities Allied Corporation, discussed infra, pp. 1453–7.

[153] Op. cit. supra, note 72, Commission's Exhibit No. 2001.

[154] From 1930 to 1937, the market price index for investment company securities remained below that of the general market. See Part Two (House Doc. No. 70, 76th Cong.), Ch. IV, pp. 315–17, of this report. After 1929 the securities of investment companies consistently sold in the market at prices substantially less than their asset values. As the Delaware Chancery Court has recently said in disapproving the use of the market value of an investment company security as the only index for determining the appraisal value of a dissenting stockholder's share in a consolidating investment company:

> When it is said that the appraisal which the market puts upon the value of the stock of an active corporation as evidenced by its daily quotations is an accurate fair reflection of its intrinsic value, no more than a moment's reflection is needed to refute it. There are too many accidental circumstances entering into the making of market prices to admit them as sure and exclusive reflectors of fair value. The experience of recent years is enough to convince the most casual observer that the market in its appraisal of values must have been woefully wrong in its estimates at experience of recent years is enough to convince the most casual observer that the market in its appraisal of values must have been woefully wrong in its estimates at one time or another within the interval of a space of time so brief that fundamental conditions could not possibly have become so altered as to affect true worth. Markets are known to gyrate in a single day. The numerous causes that contribute to their nervous leaps from dejected melancholy to exhilarated enthusiasm and then back again from joy to grief, need not be reviewed. It would be most unfortunate indeed either for the consolidated corporation or for the objecting stockholder, if on the particular date named by the statute for the evaluation of the dissenter's stock, viz.

investment company subsidiaries available for market trading, from 1933 to 1935, would detract from the reliability of the market quotations of such securities as an accurate reflection of their real worth. The floating supply of these subsidiaries' securities available for market trading progressively declined as Atlas Corporation continued to make purchases of such securities. Finally, the market prices of its investment company subsidiaries whose securities were included in the portfolios of investment companies which were dissolved by Atlas Corporation in 1933 and 1935, represented, to a substantial extent, the prices that Atlas Corporation was willing to pay for them.

The senior securities, that is, the securities having asset values, of Federated Capital Corporation, National Securities Investment Company, American, British & Continental Corporation, and American Investors, Inc., shares of which were included in the portfolios of the investment companies dissolved by Atlas Corporation, were traded in only over the counter. The markets in Federated Capital Corporation and National Securities Investment Company stock were quoted by P. H. Whiting & Co., Inc., and A. G. Becker & Co., respectively, who were the original distributors of the shares, and both of whom were assisting Atlas Corporation to acquire the shares.[155] Their market quotations were substantially the prices quoted by Atlas Corporation.[156] Similarly, Blyth & Company and J. Henry Schroder Banking Corporation, the former sponsors of American, British & Continental Corporation, who presumably would be the source of any market quotations for their company's securities, were acting as brokers for Atlas Corporation.[157] It may be inferred, therefore, that Atlas Corporation's purchases were a determining factor in fixing the market prices of the securities of its investment company subsidiaries which were sold only over the counter.

With the exception of the securities of Blue Ridge Corporation, comparatively few of which were acquired by Atlas Corporation in the open market,[158] the purchases by Atlas Corporation of the securities of its affiliates which were listed on securities exchanges were also a substantial factor influencing the market prices of these securities. A comparison of the recorded volume of trading in the securities of its investment company affiliates whose stocks were held by the companies dissolved by Atlas Corporation in 1933 and 1935, indicates that Atlas Corporation's purchases were substantially responsible for the total volume of trading in those securities, and were a substantial factor in the determination of the market prices of such shares.[159] However, it is not to be inferred that Atlas Corporation was engaged in manipulative activities.

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the date of the consolidation, the market should be in one of its extreme moods and the stock had to be paid for at the price fixed by the quotations of that day. Even when conditions are normal and no economic forces are at work unduly to exalt or depress the financial hopes of man, market quotations are not safe to accept as unerring expressions of value. The relation of supply to demand on a given day as truly affects the market value of a stock as it does of a commodity; and temporary supply and demand are in turn affected by numerous circumstances which are wholly disconnected from considerations having to do with the stock's inherent worth. (*Chicago Corporation* v. *Munds*, 20 Del. Ch. 142, 172 Atl. 452 (1934).)

[155] See supra, pp. 1289 and 1111–14.

[156] Ibid.

[157] Op. cit. supra, note 72, Commission's Exhibit No. 2001.

[158] Ibid.

[159] The following tab'e indicates the recorded volume of trading on securities exchanges during 1933 and 1934 in the shares of Atlas Corporation's subsidiaries in existence in 1934 which possessed asset values, and also indicates the total purchases of such securi-

Nevertheless, in most cases these market prices were the basis for the determination of the distributive shares of the dissolved corporations received in cash by their minority stockholders. It is not to be inferred that Atlas Corporation was required to use the asset values of its controlled investment companies' securities in the portfolios of the dissolved companies in determining the cash liquidating dividends to be paid to minority stockholders. However, the basis for evaluation of the dissolved corporations' assets was fixed solely by Atlas Corporation, and no independent appraisal of the value of the assets for cash distributive purposes was made. In the exercise of its absolute discretion, Atlas Corporation could evaluate on a market, asset, or any other basis.[160] However, regardless of the basis of evaluation of his cash distributive share, a minority stockholder could and in some instances did obtain his distributive share of the portfolio securities and other assets of his company in kind. In such instances,

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ties both on the exchanges and over the counter by Atlas Corporation and its controlled investment companies:

Name of company	Exchange on which listed	Recorded volume, 1933	Purchases by Atlas Corporation group, 1933	Recorded volume, 1934	Purchases by Atlas Corporation group, 1934
Pacific Eastern Corporation	New York Curb	231,402	380,854	79,000	150,831
National Securities Investment Co., pfd.	Chicago Stock	450	1,741	500	8,096
Sterling Securities Corporation, 1st pfd.	New York Stock	24,807	20,704	11,800	10,196
Sterling Securities Corporation, $1.20 pfce.	do	71,600	20,705	33,600	20,550
Sterling Securities Corporation	do	124,600	22,996	47,500	36,325
Shenandoah Corporation, pfd	New York Curb	29,871	15,392	13,600	14,317
American Investors, Inc., class B common.	do	77,904	40,708	8,750	11,605

The figures used are derived from op. cit. supra, note 72, Commission's Exhibit No. 2001, and *Bank and Quotation Record.*

[160] In the case of Atlantic Securities Corporation, the distributive share of minority stockholders was based on an evaluation of the corporate assets other than by market values. On a market valuation of the assets of the corporation, preferred stockholders would have received $45.57 a share of their stock, although pursuant to the corporation's charter they were entitled to a priority in assets to the extent of $52,50 a share plus accrued unpaid dividends which then totaled $6.25 a share. The common stock of the corporation, if its assets were evaluated at market, would have been entitled to none of the assets. However, the corporate assets, on the basis of the actual asset value of the securities of Atlas Corporation's undissolved subsidiaries held by Atlantic Securities Corporation, were sufficient to entitle each preferred stockholder to the full claim of his shares; that is, to $58.75 a share, and each common stockholder to $7.08 a share. Atlas Corporation actually paid to each minority preferred stockholder $58.75 on each share of his stock as a liquidating dividend, and paid to each minority common stockholder the sum of $3 a share in cash as a liquidating dividend (op. cit. supra, note 72, Commisson's Exhibit No. 2001). In other words, minority preferred stockholders received a liquidating dividend based on an evaluation of the corporate assets on the basis of the asset values of its portfolio of other affiliated investment company securities; minority common stockholders received less than half of the sum to which they would have been entitled on the same basis. The record does not indicate why Atlas Corporation employed a non-market-value basis of evaluation in the case of Atlantic Securities Corporation and not in other cases. Atlantic Securities Corporation, however, illustrates the extent to which the sense of fairness of the management of a parent investment company, coupled with a privilege of the minority stockholder of the subsidiary company to receive his distributive share of the portfolio securities in kind, was substantially the only protection to minority stockholders against the completely unsupervised power of a parent investment company to determine the value of a subsidiary company's assets on its dissolution, and, as a corollary, the value of the minority stockholder's pro rata cash share in such assets.

minority stockholders received precisely the same treatment, pro rata, as Atlas Corporation.

(1) DISSOLUTION OF CHATHAM PHENIX ALLIED CORPORATION (SECURITIES ALLIED CORPORATION)

As has already been described elsewhere in this chapter,[161] Chatham Phenix Allied Corporation (or Securities Allied Corporation, as the company was renamed after its control passed to Atlas Corporation in August 1931,[162]) on the very day that its control was acquired by Atlas Corporation, purchased from Atlas Corporation and its affiliates substantial blocks of the securities of other Atlas Corporation controlled investment companies. Thereafter, as Mr. Odlum testified, "Securities Allied * * * was the main stem through which the other companies were held." [163] On December 8, 1933, the date of the dissolution of Chatham Phenix Allied Corporation, approximately 76% of its portfolio of securities consisted of substantial stock interests in other Atlas Corporation controlled companies which had either already been dissolved or had survived the dissolution of Securities Allied Corporation.

The activities of Securities Allied Corporation were changed from investment in diversified securities to the status of an intermediate holding company for the securities of Atlas Corporation's controlled investment companies. By June 1933, Securities Allied Corporation had acquired substantial majority interests in several of Atlas Corporation's affiliates. It held 93% of the stock of Allied Atlas Corporation, 80% of the Stock of All America General Corporation, 77% of the stock of Aviation Securities Corporation, 69% of the stock of Chain Stores Stocks, Inc., 11% of the stock of General Empire Corporation, and 55% of the stock of Ungerleider Financial Corporation, all of which were nonleverage companies.[164] All of these companies were liquidated from June to December 8, 1933, the date of the dissolution of Securities Allied Corporation.[165] As a result of these liquidations, Securities Allied Corporation acquired as liquidating dividends in kind, on its holdings of the shares of these companies, many diversified securities and substantial blocks of the securities of American Investors, Inc., Pacific Eastern Corporation, Shenandoah Corporation, Sterling Securities Corporation, Blue Ridge Corporation, and American, British & Continental Corporation,[166] all of which, with the exception of Pacific Eastern Corporation, were leverage investment companies.

These investment companies controlled by Atlas Corporation were not dissolved or consolidated with Atlas Corporation until 1935 and 1936. And these securities, at the date of the dissolution of

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[161] See supra, p. 1149.

[162] Ibid.

[163] Op. cit. supra, note 72, at 18234.

[164] Id., Commission's Exhibits Nos. 2038, 2040.

[165] Id., Commission's Exhibit No. 2001.

[166] Securities Allied Corporation acquired in this manner 34,803 shares of the Class B common stock of American Investors, Inc.; 376,971 shares of the capital stock of Pacific Eastern Corporation (formerly known as The Goldman Sachs Trading Corporation); 27,594 shares of the preferred stock of Shenandoah Corporation; 21,828 shares of the preferred stock of Blue Ridge Corporation; 33,814 shares of the preferred stock of Sterling Securities Corporation, and 9,418 shares of the preferred stock of American, British & Continental Corporation (id., Commission's Exhibit No. 2040).

Securities Allied Corporation, had asset values greatly in excess of their market values. The disparity between the market value and asset value of the holdings of Securities Allied Corporation (part of which were purchased and part of which were received as liquidating dividends from previously dissolved subsidiaries) in the surviving investment companies controlled by Atlas Corporation, is indicated in Table 21:[167]

TABLE 21.—*Valuation of securities of investment companies in the portfolio of Securities Allied Corporation, on the basis of market and asset values, end of 1933*

Name of portfolio company	Number of shares	Valuation used for distributive purposes [a]		Valuation at underlying asset values, Dec. 31, 1933		Difference representing excess of underlying asset-value basis over values used for distributive purposes [b]	
		Per share	Total	Per share	Total	Per share	Total
Preferred stocks							
American, British & Continental Corp. $6 cum	34,018	$15.00	$510,270.00	$32.43	$1,103,203.74	$17.43	$592,933.74
Blue Ridge Corp. cum. op. $3 conv	30,755	32.00	984,160.00	55.25	1,699,213.75	23.25	715,053.75
Federated Capital Corp. 6% cum	74,074	11.00	814,814.00	22.78	1,687,405.72	11.78	872,591.72
National Securities Investment Co. 6% cum	82,672	58.63	4,847,059.36	78.30	6,473,217.60	19.67	1,626,158.24
Shenandoah Corp. op. $3 conv	27,594	17.25	475,996.50	27.11	748,073.34	9.86	272,076.84
Sterling Securities Corp. conv. 1st $3 cum	84,471	29.25	2,470,776.75	57.00	4,814,847.00	27.75	2,344,070.25
Sterling Securities Corp. conv. $1.20 cum	38,985	3.50	136,447.50	.86	33,527.10	(2.64)	(102,920.40)
Common stocks							
American Investors Inc., "B"	273,603	2.50	684,007.50	3.53	965,818.59	1.03	281,811.09
Federated Capital Corp	50,592.4725	1.00	50,592.47			(1.00)	(50,592.47)
National Securities Investment Co	691,219.5						
Pacific Eastern Corporation	493,077	1.625	801,250.13	4.07	2,006,823.39	2.445	1,205,573.26
Sterling Securities Corp. "A"	23,496	1.625	38,181.00			(1.625)	(38,181.00)
Sterling Securities Corp. "B"	40,403	−.125	5,050.38			(−.125)	(5,050.38)
			11,818,605.59		19,532,130.23		7,713,524.64

[a] Market valuations used except in the case of National Securities Investment Co. 6% cumulative preferred stock, the market value of which was $40 a share.
[b] Figures in parentheses represent excess of valuation for distributive purposes (market valuation) over underlying asset values.

Source: See note 167 in text.

[167] The figures cited in this table are derived from Pt. III of the reply to the Commission's questionnaire for Securities Allied Corporation, and Pts. I and II of the replies to the Commission's questionnaire for the companies listed in the table, as well as from supplementary information supplied the Commission for Securities Allied Corporation. See also op. cit. supra, note 72, Commission's Exhibit No. 2001 (p. 122).

As has already been indicated, the market values of substantially all of these securities were predominantly a reflection only of the price that Atlas Corporation, as virtually the only market bidder for such securities, was willing to pay for them. However, Mr. Odlum testified that the prices paid by Atlas Corporation for these securities were higher than the prices at which comparable investment trust issues were then selling in the market.

The difference of $7,713,524.64 between the asset and market value of these securities contained in the portfolio of Securities Allied Corporation was approximately $5 a share on all outstanding shares of the stock of Securities Allied Corporation. To Atlas Corporation the asset values of these securities were meaningful values, since, as has already been pointed out, it held directly or indirectly a sufficient amount of the voting securities of these companies to possess either the absolute or the practical power to dissolve these companies or to consolidate them with itself. Minority stockholders of Securities Allied Corporation who had refused to sell their shares to, or to exchange their shares for Atlas Corporation securities, may have been content to accept the Atlas Corporation policy of investment of the funds of their corporation in purchases at a discount from asset values of the securities of other investment companies. The consolidation of the investment companies whose securities were in the portfolio of Securities Allied Corporation with Atlas Corporation and Securities Allied Corporation, on a basis recognizing asset values, or the prior dissolution of those investment companies whose securities were held by Securities Allied Corporation, might have assured the minority stockholders of Securities Allied Corporation of participation in the profits involved in the investment policy adopted by Securities Allied Corporation under the management of Atlas Corporation. On the other hand, however, the dissolution, consolidation, or merger with Atlas Corporation of the investment companies whose securities were held by Securities Allied Corporation on the date of its dissolution, would have destroyed any further profits to be derived by Atlas Corporation by the continued purchase of their stock at discounts from their assets values.

This conflict between the pecuniary advantages to Atlas Corporation in keeping alive the investment companies whose securities were held in the portfolio of Securities Allied Corporation, and the interests of the latter's minority stockholders, is illustrated in the failure of Atlas Corporation to dissolve National Securities Investment Company, the majority of whose outstanding securities were in the portfolio of Securities Allied Corporation on the date of its dissolution. Securities Allied Corporation's holdings of 691,219½ shares of the common stock of National Securities Investment Company constituted 74% of that company's outstanding common shares, and its holdings of 82,672 shares of National Securities Investment Company's preferred stock represented 60% of such stock then outstanding.[168]

In other words, Securities Allied Corporation itself had the absolute power to dissolve National Securities Investment Company. The

[168] Op. cit. supra, note 72, Commission's Exhibit No. 2040.

common stock of National Securities Investment Company had no asset value, but the company's preferred stock had an asset value as at December 31, 1933, of $78.30 a share as compared with a market price of $40 a share.[169] The problem is presented whether Atlas Corporation in the interests of minority stockholders of Securities Allied Corporation should have attempted to realize as fully as possible the inherent value of the portfolio securities held by Securities Allied Corporation. The interests of the minority stockholders of Securities Allied Corporation would require the dissolution of National Securities Investment Company, which, however, would end the possibility of profits to Atlas Corporation in the further purchase of National Securities Investment Company's preferred stock at a discount from its asset value.

Atlas Corporation resolved this conflict between its own interests and the interests of the minority stockholders of Securities Allied Corporation in favor of the continuance of the corporate existence of National Securities Investment Company. In 1934, Atlas Corporation purchased 9,346 shares of National Securities Investment Company preferred stock at a total cost of $588,918.58. These shares had an aggregate asset value of $716,762.24, so that Atlas Corporation on the purchase of these shares derived a profit in terms of asset values of $127,843.66.[170]

However, Atlas Corporation, although it did not dissolve National Securities Investment Company, made concessions to the minority stockholders of Securities Allied Corporation. For distribution purposes it valued the holdings of National Securities Investment Company preferred stock in the portfolio of Securities Allied Corporation at $58.63 a share, a figure approximately midway between its market value of $40 a share and its asset value of $78.30 a share.

As in the cases of most of the other investment companies acquired and dissolved by Atlas Corporation, stockholders of Securities Allied Corporation were privileged to elect to receive their distributive share of the corporation's assets in kind in securities contained in the company's portfolio. And as in all other cases, Atlas Corporation elected to receive its liquidating dividends in portfolio securities.[171]

Atlas Corporation was, as has been indicated, in a position to realize the asset values of the investment company securities which

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[169] This asset value is based on a consolidation of the assets of National Securities Investment Company with the assets of Federated Capital Corporation, the securities of which were not owned by National Securities Investment Company on December 8, 1933, when Securities Allied Corporation was dissolved, but were conveyed to National Securities Investment Company on December 29, 1933 (id., Commission's Exhibit No. 2001, pp. 235–6). Although the asset value of National Securities Investment Company's preferred stock as at December 8, 1933, was not disclosed by the record, such asset value on June 30, 1933, was $79.69, based on the market value of its portfolio, and $81.21, taking the company's holdings of American, British & Continental Corporation's securities at their asset values (Reply to the Commission's questionnaire for National Securities Investment Company, Pt. I, Exhibit 8).

[170] Op. cit. supra, note 72, at 18027.

[171] Id., Commission's Exhibit No. 2001, p. 122. Atlas Corporation and its controlled companies received as an initial liquidating dividend from Securities Allied Corporation, cash in the sum of $5,687,332.96 and securities (the bulk of which were the securities of controlled investment companies) having a market value of $14,309,194.69. However, the asset value of the securities of its controlled investment companies which Atlas Corporation received was $6,777,617.99 in excess of their market value. Atlas Corporation and its subsidiaries also retained an equity of $471,952.21 in the remaining undistributed assets of Securities Allied Corporation (ibid.).

it received in kind. However, to the minority stockholders, the portfolio securities receivable as liquidating dividends in kind were immediately worth only their market values. Minority stockholders who were aware of the higher asset value of these securities and who were willing to retain them until Atlas Corporation determined to dissolve or consolidate the companies whose securities were held by Securities Allied Corporation, would eventually realize the same profit which would accrue to Atlas Corporation as the result of the investment policy it had pursued with the funds of Securities Allied Corporation. Atlas Corporation alone, however, was in sole control of the time of dissolution or consolidation, if ever, of these companies. However, the fact is that the great number of minority stockholders of Securities Allied Corporation elected to receive their dividends in cash only. Of the 43,972 shares of the corporation held by minority stockholders, holders of 41,194 shares elected to receive their dividends in cash.[172]

The cash liquidating dividend to be paid to minority stockholders was based on the market values of the portfolio securities held by Securities Allied Corporation, with the exception of the preferred stock of National Securities Investment Company which was, as has already been pointed out, evaluated on another basis. The cash necessary for the distribution made to minority stockholders was obtained by the sale at market prices of a sufficient amount of Securities Allied Corporation's portfolio securities through brokers to Atlas Corporation and its subsidiaries.[173] Actually, therefore, the great number of the minority stockholders of Securities Allied Corporation did not participate in the profits inherent in the program of investment in investment companies entered into by Securities Allied Corporation under the management of Atlas Corporation, although they were given the option to participate in such profit by accepting a distribution in kind instead of a distribution in cash.

C. Mergers, Consolidations, and Sales of Corporate Assets

As has been prevously pointed out, the merger or consolidation of investment companies or the transfer of all, or substantially all, of the assets of one such company to another company in exchange for the latter's securities, effectuates, in essence, a readjustment of the participations of the stockholders of the various companies in the earnings and assets of their former companies. And the assent of a prescribed percentage of stockholders to such plans in many states binds dissenting stockholders to such plans as a matter of law. In other words, such plans represent in essence "a forcible exchange of participations in one concern for participations in a larger concern." [174]

Despite the possible drastic effect of plans for mergers, consolidations, or sales of the assets of investment companies upon the rights and participations of shareholders, the preparation and promulgation

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[172] Derived from supplementary information supplied the Commission for Securities Allied Corporation.

[173] Ibid.

[174] Berle, A. A., and Means, G. C., *The Modern Corporation and Private Property* (1934), p. 172.

of such plans is normally controlled by the managements of the corporations involved. No independent, unbiased agency passes upon the terms of management-prepared plans. Nor are the solicitation methods adopted to secure the consent of stockholders to such plans ordinarily subject to any administrative check. As has already been indicated, the literature prepared by the management for use in soliciting acceptances by stockholders of plans for the merger, consolidation, or sale of their corporation's assets, at present, is not required to be registered under the Securities Act of 1933. The Securities Exchange Act of 1934 empowers the Commission to make rules and regulations with respect to the solicitation, by the mails or by any means or instrumentality of interstate commerce, of proxies, consents, or authorizations with respect to these plans only where the securities are listed on national securities exchanges. However, as has been pointed out,[175] the securities of most existing investment companies are not listed on exchanges. In reality, therefore, the bulk of investment companies are free from any administrative supervision of their mergers, consolidations, or of sales of their assets.

The interests of the management of a corporation in a merger, consolidation, or sale of all of the corporate assets may conflict sharply with those of the stockholders. Moreover, the ability of the management to select and control these procedures for the amalgamation of corporations may enable it in many cases to circumvent statutory safeguards for the protection of stockholders. This power, coupled with the management's control of the proxy machinery, will often enable it to perpetrate plans of merger or consolidation which may be in many aspects detrimental to the interest of the public holders of the securities of the various corporations involved.

1. MANAGEMENT SELECTION AND CONTROL OF AMALGAMATION PROCEDURES

The remedies available to stockholders dissenting from a merger or other plan which may adversely affect their interests are normally limited to a privilege to obtain in cash an appraised value of their securities or to an attempt to prevent the consummation of the plan by litigation. The defects in these remedies have already been indicated.[176] In several states, as has been pointed out, no privilege to receive an appraised value of his securities is available to a dissenting stockholder. In others, appraisal rights may be granted in the case of a merger or consolidation, but not in the case of a sale of the corporate assets. For example, in Delaware, the state of incorporation of most investment companies, a dissenting stockholder may obtain an appraised value of his stock in cash where a merger or consolidation of his company with others is contemplated but not where the sale of the corporation's assets to another corporation for the latter's securities is projected.[177] Moreover, in Delaware the consent of the holders of two-thirds of the outstanding shares of all classes of securities of merging or consolidating corporations must be obtained, although for other purposes some of the corporate securities, such as

[175] See this section, supra, p. 1411.
[176] Ibid.
[177] See Del. Rev. Code (1935), c. 65, §§ 59, 61, 65.

preferred stocks, may have no voting rights.[178] On the other hand, a sale of all the corporate assets of a Delaware corporation requires only the consent of the holders of a majority of the shares having voting power.[179] As a consequence, holders of non-voting securities, such as preferred stocks, may have no voice in the disposition of their corporate assets. For example, the Delaware corporation law permits the majority holders of the common stock, which may have no asset value, to dispose of the corporate assets to another corporation on terms which may be advantageous to common stockholders but disadvantageous to preferred stockholders. The latter stockholders may be powerless to prevent such disposition and have no recourse to the remedy of apraisal.

The sale of assets method of amalgamating investment companies is of additional advantage to those in control of such companies in that stockholders of the purchasing corporation as well as those of the selling corporation have no appraisal rights. Nor do the stockholders of the purchasing corporation have any voice in the determination to purchase the assets of another entity. The directors alone have the power, without consultation with the stockholders, to acquire all of the assets of another investment company. Such a purchase may present many problems with respect to the stockholders of the purchasing corporation. For example, as has already been related in detail elsewhere in this chapter,[180] in May 1931, General Empire Corporation acquired, in exchange for its securities, all of the assets of Power and Light Securities Trust, a Massachusetts trust engaged in the business of investing in the securities of public utility corporations. At this time, Power and Light Securities Trust was 95% owned by Atlas Corporation, which, as a consequence, acquired the bulk of the stock of General Empire Corporation issued in exchange for the assets of Power and Light Securities Trust. The General Empire Corporation stock received by Atlas Corporation as the result of the transaction constituted the controlling block of General Empire Corporation's stock.

General Empire Corporation had been incorporated in Delaware in 1929 to invest in the securities of commercial banks and had conformed its investments to this announced policy. As a consequence of the purchase of the assets of Power and Light Securities Trust, stockholders of General Empire Corporation became shareholders in a company which, in addition to its holdings of bank stocks, now held a substantial portfolio of securities of public utility companies. Moreover, their corporation was controlled by Atlas Corporation whose purpose was to change the investment policy of General Empire Corporation to that of purchasing other investment company securities.[181]

Notwithstanding this substantial alteration in the character of their corporation's investments, stockholders of General Empire Corporation did not have under the law of Delaware the privilege to

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[178] Id., § 59. The vote of the holders of each merging or consolidating corporation's shares, representing two-thirds of the total number of shares of its capital stock, is required for approval of the merger or consolidation (ibid.).

[179] Id., § 65.

[180] See supra, pp. 1258–70.

[181] Op. cit. supra, note 72, at 17933.

demand an appraised value in cash for their stock in the corporation.

Similarly, minority certificate holders in Power and Light Securities Trust became stockholders in a corporation owning a substantial block of bank stocks at a time when banks were in a precarious financial condition.[182] Following the sale of its assets, Power and Light Securities Trust was dissolved. Minority certificate holders had no right to receive in cash an appraised value of their certificates in lieu of either their pro rata share in kind of the securities of General Empire Corporation received in payment for the trust's assets, or of the market value of such pro rata share. As has been stated, no statutory privilege to receive an appraisal value of their shares is accorded to the certificate holders of a business trust on the sale of its assets to another entity. Nor did the trust indenture [183] creating Power and Light Securities Trust grant such a privilege.

In Delaware and in states having similar statutory provisions the sale of assets method of amalgamation of investment companies is most likely to be selected by a corporate management actuated by self-interest. In other states, such as Maryland (another popular state for the incorporation of investment companies), where the assent of holders of two-thirds of the voting securities (or if there are classes of voting securities, two-thirds of each class) is required for the consummation of a merger, consolidation, or sale of the corporate assets and where the right of appraisal exists irrespective of the procedure adopted, statutory safeguards erected in the interests of stockholders may be circumvented by ingenious managements. For example, the necessity for the consent of the holders of two-thirds of the voting shares to a merger or consolidation or a sale of assets may be avoided in Maryland by a charter provision [184] either at the time of incorporation or later by amendment, authorizing the consummation of any of these transactions with the consent of only a majority of the voting shares irrespective of class.

In sum, corporate managements not only have the sole power to prepare plans for the absorption of the corporate assets by another corporation, but also to select the procedure for such absorption most calculated to insure the success of the plan in the face of possible stockholder opposition. Managements actuated by self-interest may use such power in a manner which may be detrimental to the interests of many of the shareholders.

a. Consolidation of National Investors Corporation and Affiliated Corporations

The amalgamation, in 1937, of the assets of National Investors Corporation and its affiliated corporations, Second National Investors Corporation, Third National Investors Corporation, and Fourth National Investors Corporation, to form a new open-end company retaining the name of National Investors Corporation, involved a substantial dilution in the asset value of the securities held by stockholders of the affiliated companies in order to create asset values for

[182] Id., at 17933–4.
[183] Id., Commission's Exhibit No. 1971.
[184] Md. Code, Ann. (Flack Supp. 1935), Art. 23, § 23.

the equity securities and warrants of the original parent company, National Investors Corporation. The plan was proposed and carried through by the interlocking board of directors of all of the companies, notwithstanding the fact that a similar plan proposed in 1934 had been defeated as a result of the organized opposition of the stockholders of the affiliated companies. The sale of assets technique was apparently adopted by the management to deny any appraisal rights to dissenting stockholders of the affiliated companies, all of which were Delaware corporations.

National Investors Corporation was incorporated in New York on June 16, 1927, under the sponsorship of Fred Y. Presley and Guardian Detroit Company, the then security affiliate of the Guardian Detroit Bank, for the purpose of managing and investing its capital in the securities of affiliated investment companies to be subsequently formed. The capitalization of National Investors Corporation consisted of 40,000 shares of preferred stock entitled on liquidation of the company to a preference in assets of $100 a share, 40,000 shares of common stock and 160,000 option warrants. Guardian Detroit Company, as partial compensation for its distribution of the company's securities, received 100,000 of the warrants of which it retained 50,000 and distributed the remaining 50,000 among Mr. Presley, other banks assisting in the distribution of National Investors Corporation's securities, and individuals who became members of the board of directors of National Investors Corporation. The preferred and common stock and 60,000 warrants were privately sold in units of one share of preferred, one share of common and one and one-half warrants, primarily to banks located throughout the United States, particularly banks which would cooperate in the distribution to their depositors of the shares of the affiliated companies of National Investors Corporation which were to be formed. As Mr. Presley testified, banks were an "important factor as stockholders" of National Investors Corporation.[185] Through the sale of its securities and the exercise of warrants, National Investors Corporation raised approximately $5,000,000, all of which was, as will be described hereafter, invested in the securities of its affiliated corporations.[186] As the result of stock and warrant split-ups and the exchange of preferred for common stocks, National Investors Corporation ultimately had outstanding 14,858 shares of preferred stock, 792,519 shares of common stock, and option warrants to purchase 381,336 shares of its common stock at $2.33½ a share until July 1, 1935, and thereafter at $0.33⅓ a share more per annum until July 1, 1938, when the warrants expired.[187]

On November 9, 1928, the first of the affiliated investment corporations, Second National Investors Corporation, was incorporated, again under the sponsorship of Guardian Detroit Company and Mr. Presley. This corporation was not organized under the laws of New York, the place of incorporation of National Investors Corporation, but in Delaware, whose corporation laws, Mr. Presley testified, were more "flexible" both from the viewpoint of the management and of the stockholders. Mr. Presley explained that incorporation of National Investors Corporation under the more "conservative" laws

[185] Public Examination, National Investors Corporation, at 4331.
[186] Id., at 4323–5.
[187] Id., Commission's Exhibit No. 441.

of New York was made necessary by the fact that a Delaware corporation would not be "readily acceptable" to the banks to whom a substantial amount of the securities of National Investors Corporation was distributed.[188]

The capitalization of Second National Investors Corporation consisted of 100,000 shares of preferred stock entitled on liquidation to a preference in assets to the extent of $100 a share and accrued unpaid dividends, 300,000 shares of common stock, and option warrants to purchase 200,000 shares of common stock on or before December 31, 1943, at a price of $25 a share. National Investors Corporation purchased 100,000 shares of Second National Investors Corporation's common stock and all of its option warrants for a cash consideration of $1,000,000. The remaining 100,000 shares of the company's preferred stock and 200,000 shares of its common stock were sold to the public by an underwriting group headed by Guardian Detroit Company and Shawmut Corporation of Boston, the security affiliate of The National Shawmut Bank of Boston, for proceeds of $10,000,000 of which Second National Investors Corporation received $9,600,000, the remainder being retained as selling commission by the underwriters.[189]

On February 21, 1929, Guardian Detroit Company and Mr. Presley caused Third National Investors Corporation to be incorporated in Delaware. The capitalization of this company consisted of 200,000 shares of common capital stock and option warrants to purchase 130,000 shares of the company's stock at a price of $60 a share until March 1, 1934, and thereafter at $2 a share more per annum until March 1, 1939. National Investors Corporation invested $1,000,000 in the purchase of 20,000 shares of the common stock and all of the option warrants of Third National Investors Corporation. Of the warrants so acquired, National Investors Corporation retained 102,000 and distributed the remainder to the members of the selling group which publicly sold 180,000 shares of Third National Investors Corporation's stock for proceeds to the corporation of $8,400,000.[190]

Fourth National Investors Corporation, the last of the affiliates of National Investors Corporation, was organized in Delaware on August 13, 1929, again under the auspices of Guardian Detroit Company and Mr. Presley. The capitalization of this company consisted of 500,000 shares of common capital stock and option warrants to purchase 1,000,000 shares of the corporation's stock at $60 a share on or before October 2, 1939. All of the company's stock and warrants to purchase 250,000 shares of its stock were sold to the public in units of one share of stock and a nondetachable warrant to purchase one-half share of the company's stock. From the public sale of these securities the corporation realized $24,000,000.[191] National Investors Corporation purchased for $3,000,000 from Fourth National Investors Corporation option warrants to purchase 750,000 shares of the corporation's stock.[192] At the conclusion of the financing of all the National Investors Corporations, approximately $50,000,000 had been contributed to them by the investing public. Control of the

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[188] Id., at 4274–5.
[189] Id., at 4275, 4277, 4279.
[190] Id., at 4295, 4301–2.
[191] Id., at 4310.
[192] Id., at 4317.

system, however, was vested in the common stockholders of National Investors Corporation, which had invested its entire capital funds in its affiliated companies as follows:

	Number of shares	Percent of total	Number of warrants	Percent of total	Cost
Second National Investors Corporation (common)	100,000	33⅓	200,000	100	$1,000,000
Third National Investors Corporation (common)	20,000	10	102,000	77	1,000,000
Fourth National Investors Corporation			750,000	75	3,000,000
					5,000,000

Of the warrants of Fourth National Investors Corporation, 65,000 were immediately sold by National Investors Corporation at $12.50 a warrant, thus reducing its holdings to 685,000 warrants at a net cost of $2,187,500.[193]

In addition to its security interests in its affiliates, National Investors Corporation also acted as their manager. On their formation, the affiliated companies entered into a contract with National Investors Corporation by which the latter was to manage their assets for an annual fee of ¾ of 1% of the assets of each of the affiliates. These contracts expired on December 31, 1934, but were renewed in 1935, and expired at the date of the consolidation of the four companies in 1937. National Investors Corporation delegated the management functions to Fred Y. Presley, its president, who was paid an annual fixed salary plus an additional annual fee equivalent to $\frac{1}{100}$ of 1% of the assets of the affiliated corporations. Mr. Presley's compensation from 1930 to 1934, when the first plan of reorganization of the four companies was promulgated, averaged in excess of $30,000 per annum.[194]

Following the crash in the market values of securities in 1929, the assets of the National Investors system of investment companies shrank sharply in value. By September 1934 the assets of the group of companies totaled approximately $25,000,000, as compared with the original total capitalization of the group of approximately $50,000,000. The stocks of the various companies themselves were selling in the market at prices substantially below their asset values, with the exception of the negative asset value common stocks of National Investors Corporation and Second National Investors Corporation, both of which were leverage companies.[195]

The low prices at which the negative asset value common shares of National Investors Corporation were selling in the open market, coupled with the substantial discounts from asset value at which the securities of the affiliated companies were selling in the open market, invited attempts by individuals and other investment companies to acquire control of the system of companies in order to profit by exchanges of their securities for the securities of the system or by the use of the assets of the group of companies to further their own purposes. And, as Mr. Presley testified, the pyramided character

[193] Id., at 4321.
[194] Id., at 4284, 4291, 4500.
[195] Id., Commission's Exhibit No. 441.

of the National Investors Corporation group of companies facilitated the acquisition of control, since a comparatively small investment in the common shares of National Investors Corporation would carry with it control of the assets of the entire system. A possibility of a shift in control of the group of companies was intensified in March 1933 by the insolvency of the Guardian Detroit group of banks and their security affiliate, Guardian Detroit Company, which owned outright or held as collateral for loans approximately 150,000 shares of the common stock of National Investors Corporation. The receivers of the Guardian Detroit banking system were seeking to liquidate this block of the common stock of National Investors Corporation which constituted approximately 20% of the outstanding shares of such stock. Mr. Presley attempted unsuccessfully to secure "friendly" purchasers for these holdings.[196]

Prior to the collapse of the Guardian Detroit banking system, Mr. Presley had been approached by various individuals who were desirous of acquiring control of the National Investors Corporation group of companies. For example, Mr. Presley was approached in 1932 by Wallace Groves, who sought Mr. Presley's assistance in the purchase of a controlling block of the common stock of National Investors Corporation. In Mr. Presley's opinion Mr. Groves felt that he would have little chance of succeeding without Mr. Presley's aid. In fact, Mr. Groves promised to "take care" of Mr. Presley by awarding him a stock interest in the National Investors Corporation companies and by continuing him as manager and president of the National Investors Corporation companies if Mr. Groves succeeded in acquiring control of them. Mr. Presley, however, refused to aid Mr. Groves in his efforts.[197]

As has been already related in detail elsewhere in this chapter,[198] Atlas Corporation also made an unsuccessful attempt to acquire control of the National Investors Corporation group of companies. By June 1933 Atlas Corporation had acquired in the open market approximately 160,000 shares of the common stock of National Investors Corporation and substantial blocks of the securities of its affiliated corporations. As the result of Mr. Presley's refusal to assist Atlas Corporation in its contemplated exchange offers of its shares for the shares of the National Investors Corporation companies, Atlas Corporation agreed to sell to the affiliated companies its holdings of their shares at prices above their market values but less than their asset values. With the consent of the stockholders of the affiliated companies this sale was effected. Atlas Corporation, however, retained its holdings of 160,000 shares of the common stock of National Investors Corporation, which Atlas Corporation informed Mr. Presley it hoped, but did not promise, to dispose of through market channels. Notwithstanding the fact that Mr. Presley had informed Atlas Corporation that he would regard the sale of its National Investors Corporation common stock in one block as an "unfriendly act," Atlas Corporation early in 1936 sold all of its holdings of National Investors Corporation common stock to The Adams Express Company.[199]

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[196] Id., at 4513–4, 4525–6, 4531, 4541.

[197] Id., at 4516.

[198] See Sec. III, B, supra.

[199] Op. cit. supra, note 185, at 4540, 4542.

Obviously, the concentration of large blocks of the common stock of National Investors Corporation in Atlas Corporation and in the Guardian Detroit group of banks and affiliates, both of which were attempting to dispose of their holdings, constituted a serious threat to the continuance of the management of the National Investors Corporation group of companies by Mr. Presley. As Mr. Presley testified, the acquisition of these two blocks of stock, which constituted 40% of the outstanding common shares of National Investors Corporation, would insure practical control of the National Investors Corporation group of companies to the purchaser of these shares. Mr. Presley himself, by the end of 1933, did not own any of the securities of the National Investors Corporation group of companies.[200]

Meanwhile, as early as 1930, plans to consolidate the National Investors Corporation group of companies into a single company had been considered by the common board of directors of the four companies. Because of the difficulty in determining, in terms of the proposed consolidated company's shares and assets, the treatment to be accorded to the holders of the 10 different securities outstanding of the four companies, no acceptable plan had been devised by the management. By 1934, however, pressure was being exerted by an organized group of stockholders in the affiliated companies upon the management to prepare a plan to reorganize the four companies into a single open-end investment company with one class of shares redeemable by the company at the holder's option at their asset value, or, in the alternative, to transform each of the affiliated companies into an open-end company. The desirability of an open-end company from the viewpoint of this organized group of stockholders was that it would eliminate the discount from asset values at which the share of the affiliated companies were then selling in the market and would provide a permanent market for their securities at a price equivalent to their asset value. As a result of the pressure of this group of stockholders, the interlocking board of directors of the four companies appointed a committee consisting of three of their number, Mr. Presley, George Murnane of Lee, Higginson & Company, and Charles H. Diefendorf, a vice president of The Marine Trust Company of Buffalo, to prepare a plan of reorganization of the four companies for submission to the entire board of directors.[201]

As members of the boards of directors of each of the four National Investors Corporation companies, this committee was placed in the anomalous position of attempting simultaneously to serve four masters, each of whose interests were in conflict. As fiduciaries of the stockholders of all of the companies, the committee members were duty bound to obtain the best possible advantage in the reorganization of the companies for the share and warrant holders of each of the companies. However, the interests of the various share and warrant holders were in sharp conflict. The claims of the preferred stocks of National Investors Corporation and of Second National

[200] Id., at 4547.

[201] Id., at 4439, 4450, et seq. In 1934 the common board of directors of the four companies was composed of H. E. Bodman, a Detroit attorney, P. C. Cabot, a director of The National Shawmut Bank of Boston, C. H. Diefendorf and George F. Rand, both officers of The Marine Trust Company, W. S. McLucas, president of the National Bank of Detroit, George Murname, Alger Shelden, and Fred Y. Presley. (*Moody's Manual of Investments, Banks, etc.*, 1935, p. 1087, et seq.)

Investors Corporation would obviously be antagonistic to the claims of the holders of the common stock and warrants of such companies, securities which in 1934 were without asset value. Similarly, the holders of the securities of National Investors Corporation, which held substantially all of the warrants of Second, Third, and Fourth National Investors Corporation, would have interests sharply opposed to those of the stockholders of the latter companies.

To reconcile the conflicting interests of the share and warrant holders of each of these companies would be a difficult task under any circumstances. Clearly, the various security holders were entitled to an unbiased, independent representation of their interests. But the record reveals that, although the members of the management committee may have acted in good faith in the preparation of the plan proposed to the stockholders in 1934, they may not have been entirely free from bias in favor of the securities of National Investors Corporation. As Mr. Presley testified, Mr. Murnane held "a few hundred" of the warrants of National Investors Corporation, and Mr. Diefendorf's bank, The Marine Trust Company, had a "substantial investment in the warrants of the same company." [202] And, although Mr. Presley owned none of the securities of any of the National Investors Corporation companies, the consolidation of the companies into a single open-end company with one class of securities redeemable by the new company at asset value, would remove the threat to his continued management of the National Investors Corporation system represented by the blocks of the common stock of National Investors Corporation held by Atlas Corporation and the Guardian Detroit companies, both of which, as has been stated, were for sale. As Mr. Presley testified: [203]

A. It [the block held by Atlas Corporation and subsequently by The Adams Express Company] isn't control, but has certainly got veto power on anything, and would lead to control with the acquisition of the block of stock in the hands of the liquidating corporation [liquidating the assets of the Guardian Detroit system of banks and their affiliates] in Detroit.

Q. That is to say, if they joined hands with that block of stock in the liquidating corporation, it would be the largest single holding of stock in National Investors Corporation.

A. It would be close to 40 percent and control.

Q. So that it represents a serious threat to present control, does it not?

A. Yes and no.

Q. It could be used for that purpose.

A. Yes and no. It is a serious threat to control of the management company [National Investors Corporation] and to some extent a threat to the control of Second, by virtue of National's holdings of 100,000 shares of common in Second and to a lesser extent in Third and Fourth.

Q. Now, of course, that control angle represented by that stock would be eliminated in the event that you succeeded in consolidating these four companies and open-ending them.

A. That is correct.

Mr. Presley thus may have had some personal interest in effecting a consolidation of the National Investors Corporation group of companies. Obviously, however, a consolidation plan unfavorable to the

[202] Op. cit. supra, note 185, at 4486, 4492.
[203] Id., at 4546–7.

large common stockholders of National Investors Corporation would be impossible of consummation. Further, the influence of the banks in various parts of the country who were the holders of a substantial amount of the common stock and warrants of National Investors Corporation would be brought to bear against any plan unfavorable to the securities of National Investors Corporation.[204]

Nor were several of the directors, other than the committee members, entirely free from any personal interest in the allocation of values under a plan of consolidation. Of the six directors other than the members of the committee, three had at least some interest in the securities of National Investors Corporation. The record indicates that Paul C. Cabot, one of the directors, held, in 1934, approximately 1,500 of the warrants of National Investors Corporation. Shawmut Association, the security affiliate of The National Shawmut Bank, of which Mr. Cabot was a director, had also been the recipient of 14,000 warrants of National Investors Corporation on the formation of the latter company.[205] Whether or not Shawmut Association owned these warrants in 1934 is not disclosed by the record. George F. Rand, another of the directors, was president of The Marine Trust Company of Buffalo which, it will be recalled, had a substantial investment in the warrants of National Investors Corporation, and Robert C. Lord, another of the directors, had been the president of Guardian Detroit Bank until its insolvency in 1933. As has been stated, Guardian Detroit Bank and its affiliate, Guardian Detroit Company, in 1934, owned outright or held as collateral for loans approximately 150,000 shares of the common stock of National Investors Corporation.[206]

The financial problem which confronted the management committee was a complex one. The following figures indicate the asset value and market value of the outstanding securities of the four companies as at September 30, 1934, the date upon which the values allocated by the plan prepared and promulgated on December 20, 1934, were based:[207]

Name of company	Number of outstanding shares and warrants	Asset value per share or warrant	Market value per share or warrant
National Investors Corporation:			
Preferred stock	14,858	$87.08	$42.00
Common stock	792,519		1.125
Warrants	381,336		.625
Second National Investors Corporation:			
Preferred stock	82,617	63.61	35.25
Common stock	300,000		1.875
Warrants	200,000		
Third National Investors Corporation:			
Common stock	167,226	24.30	16.75
Warrants	130,000		
Fourth National Investors Corporation:			
Stock (including one-half warrant per share originally attached to stock certificates)	500,000	29.31	20.25
Warrants (excluding warrants attached to stock certificates)	750,000		

[204] Id., at 4254, 4267.
[205] Id., at 4342.
[206] See supra, p. 1464.
[207] Op. cit. supra, note 185. Commission's Exhibit No. 441.

As these figures indicate, the common stocks of both National Investors Corporation and Second National Investors Corporation were without asset value. Their position, as Mr. Presley testified, was wholly one of "future prospects." [208] And the outstanding warrants of all of the companies were also of little immediate value. Their exercise prices were substantially above the asset and market values of the securities which could be obtained upon their exercise.[209] All of the warrants of Second National Investors Corporation, 101,200 of the warrants of Third National Investors Corporation, and 685,000 of the warrants of Fourth National Investors Corporation were owned by National Investors Corporation in September 1934. These warrants had either no market value or a "pretty fictitious one." And, as Mr. Presley testified, any attempt to place a cash value upon any of the warrants of any of the companies would be "speculative" and arbitrary.[210]

A plan calculated to preserve existing asset values clearly would require the exchange of existing warrants for warrants of the new company. And the warrants of the new company acquired by National Investors Corporation in exchange for its holdings of the warrants of its affiliated companies could be distributed among its stockholders as part of such a plan. This type of plan would avoid the necessity for any appraisal of the cash value of the warrants of the existing companies. And, in fact, the warrants issued by the four companies conferred no rights upon their holders, on the merger, consolidation, or sale of the assets of any of the issuing companies, other than a right to receive warrants of the new company. Each of the warrants of the four companies contained the following provision:

> If on or before [the expiration date of the warrant] the corporation shall be combined or consolidated with or merged into another corporation, or shall transfer to any other corporation all or substantially all of its property and securities, this warrant shall be deemed to extend to the property or securities issuable, payable, or distributable in respect of the stock in respect of which this warrant is exercisable. The price at which this warrant is then exercisable for such property or securities shall be the price which would have been paid hereunder immediately prior to such combination, consolidation, or merger, or transfer in respect of the stock for which such property or securities shall have been issued, paid, or distributed.[211]

[208] Id., at 4461.

[209] The exercise price and date of expiration of the various warrants were as follows (id., Commission's Exhibit No. 441):

	Exercise price, 1934	Asset value, Sept. 30, 1934, of shares called for by warrants	Date of expiration and last exercise price
National Investors Corporation	$2.33⅓	0	June 30, 1938—$3.33.
Second National Investors Corporation	$25	0	Jan. 1, 1944—$25.
Third National Investors Corporation	$62	24.30	Feb. 28, 1939—$70.
Fourth National Investors Corporation	$60	29.31	Oct. 1, 1939—$60.

[210] Id., at 4462, 4490, and Commission's Exhibits Nos. 441, 444.

[211] See facsimile copies of the warrants of each of the National Investors corporations, contained in Pt. I of the replies to the Commission's questionnaire for these companies.

Similarly, a plan intended to preserve existing asset values of the securities of the four companies would require the exchange of the negative asset value common stocks of National and Second National Investors corporations for warrants of the new company.

In derogation of a plan of this type is the fact that it would bring to the new company a capital structure including a large number of warrants. Mr. Presley testified that his experience had indicated that option warrants were undesirable, for various reasons, in the capital structure of an investment company.[212] Although Mr. Presley's objections to the existence of option warrants in the capital structure of investment companies may have been meritorious,[213] nevertheless, the plan of consolidation of these companies actually consummated in 1937 included a provision permitting option warrant holders of the old companies to exchange them for warrants of the consolidated company.

A greater detraction, however, to the proposal of a plan preserving asset values would be the impossibility of its acceptance by the common stock and warrant holders of National Investors Corporation, who would be unlikely to approve a plan which did not give a cash asset value, in terms of the new company's shares, to their own holdings. Furthermore, the transmutation of the common stock of National Investors Corporation into warrants in a new company would destroy the control value of the large blocks of such stock held by Atlas Corporation and the Guardian Detroit system of companies.

For whatever the reason may have been the "plan of reorganization" proposed by the management committee was based, as Mr. Presley testified, upon a "compromise, not on any equity [asset] values." The "compromise" consisted essentially of a dilution of existing asset values to create a cash asset value, in terms of the new company's shares, for the common stock and option warrants of National Investors Corporation. A plan proposed by the committee to create an asset value in the new company for the common stock and warrants of National Investors Corporation by diluting, in part, the existing asset value of that company's preferred stock, was vigorously opposed by Alger Shelden, one of the directors of the four companies and a substantial holder of the preferred stock of National Investors Corporation. As a result, this plan was abandoned, and the committee's "compromise plan" was adopted. The plan proposed by the management committee of the four companies on December 20, 1934, provided for the transfer of all of the assets of the four companies to a new open-end company on a basis which would give the new company's stock an initial asset value of $10 a share. In its allocation of the shares of the new company among the existing four companies, however, the plan was highly favorable to the security holders of National Investors Corporation. That company's preferred stockholders were to receive shares in the new open-end company having a greater asset value than their existing holdings. The holders of negative asset value common stock were to receive shares in the new company having an asset value of $1.90 per share of existing common stock; the holders of warrants of National Investors Corporation which, of course, had no asset value

[212] Op. cit. supra, note 185, at 4552–3.

[213] See Ch. V of this part of the report.

were to receive shares of the new company's stock having an asset value of 90 cents per existing warrant, a sum which exceeded the then quoted market price of 62 cents for such warrants. To create these values for the securities of National Investors Corporation, the existing asset values of the affiliated companies' shares, in terms of the asset value of the shares of the new company which they were to receive, were diluted by approximately $1,800,000.[214] Table 22 indicates the treatment accorded by the plan to the securities of each of the existing companies.

TABLE 22.—*Plan for reorganization of National Investors Corporation group, proposed Dec. 30, 1934*

	Number of shares or warrants outstanding (excluding treasury)	Asset value per share or warrant	Asset value per class of stock or warrant	Market value per share or warrant	Number of new company shares (per present share or warrant)	Asset value in terms of new company shares (per present share or warrant)	Asset value in terms of new company shares (per present class of stock or warrant)
National Investors Corporation:							
Preferred stock	14,858	$87.08	$1,293,882	$42.00	8.800+	$88.00+	$1,307,587
Common stock	792,519			1.125	.19	1.90	1,505,786
Warrants	381,336			.625	.07	.70	266,935
			1,293,882				3,080,308
Second National Investors Corporation:							
Preferred stock	82,617	63.61	5,255,174	35.25	5.392+	53.92+	4,455,174
Common stock	300,000			1.875	.25	2.50	750,000
Warrants	200,000				.025	.25	50,000
			5,255,174				5,255,174
Third National Investors Corporation:							
Stocks	167,276	24.30	4,064,522	16.75	2.313+	23.13+	3,869,522
Warrants	130,000				.15	1.50	195,000
			4,064,522				4,064,522
Fourth National Investors Corporation:							
Stock (including ½ warrant per share originally attached to stock certificates)	500,000	29.31	14,655,981	20.25	2.631+	26.31+	13,155,981
Warrants (excluding warrants originally attached to stock certificates)	750,000				.2	2.00	1,500,000
			14,655,981				14,655,981
			25,269,559				27,055,985
Deduction at market values for stocks and warrants held by National Investors Corporation in other three companies			504,961				2,291,387
			24,764,598				24,764,598

Source: See note 214 in text.

[214] Op. cit. supra, note 185, at 4460, 4492, and Commission's Exhibits Nos. 440, 441.

As the table indicates, the plan required the preferred stockholders of Second National Investors Corporation to cede approximately $10 a share in asset value in order to create an asset value in the new company of $2.50 a share of Second National Investors Corporation's negative asset value common stock and 25 cents for its warrants. As National Investors Corporation owned 100,000 shares of the common stock and all of the warrants of Second National Investors Corporation, the security holders of National Investors Corporation would gain in asset value a total of $300,000 at the expense of the preferred stock of Second National Investors Corporation, none of which was owned by National Investors Corporation. Similarly, the holders of the stock of Third National Investors Corporation were to be required to sacrifice $1.17 in asset value to create an asset value of $1.50 for each of the company's warrants, 101,200 of which were owned by National Investors Corporation. Since National Investors Corporation also owned 20,243 shares of Third National Investors Corporation's stock, it suffered a loss in asset value on these shares of $23,684 but gained in asset values to the extent of $151,800 on its holdings of the warrants of Third National Investors Corporation. The net gain in asset value to National Investors Corporation at the expense of Third National Investors Corporation's stockholders was, therefore, $128,116. The largest aggregate loss, however, was suffered by the shareholders of Fourth National Investors Corporation, who were required to give up $1,500,000 in asset values to provide an asset value in terms of the new company's shares of $2 for each outstanding warrant of Fourth National Investors Corporation. Since National Investors Corporation held 685,000 of the warrants of Fourth National Investors Corporation, it derived a gain in assets at the expense of the Fourth National Investors Corporation's stockholders of $1,370,000. National Investors Corporation held only 50 shares of the stock of Fourth National Investors Corporation.[215]

It is true that the plan would accomplish the desirable result of eliminating warrants from the capital structure of the proposed new company but only the shareholders of the affiliated companies were required to make the payments necessary for the elimination of the warrants, not only of their own companies, but of those of National Investors Corporation as well. Any evaluation of the warrants would, as Mr. Presley testified, be arbitrary.[216] And, although the management committee's evaluation of the warrants in the circumstances may have been a fair one, conceivably a substantial number of the shareholders of the affiliated companies might have disagreed with it. Nevertheless, the procedure selected by the management for the effectuation of the plan was designed to avoid any possible necessity of paying to shareholders of the affiliated companies who might dissent from the plan an appraised cash value of their shares.

As has been stated, although National Investors Corporation had been incorporated in New York, the affiliated companies had been incorporated in Delaware. Under the laws of both New York and Delaware, a statutory merger or consolidation of the four companies would entitle dissenting stockholders of any of the companies to the

[215] Id., Commission's Exhibit No. 441.
[216] Id., at 4498.

payment by the new company of an appraised value of their shares. In view of the sharp losses in asset values which would be suffered under the plan by the shareholders of the affiliated companies, it could be anticipated that a large number of dissenting stockholders would demand an appraisal of their shares. On the other hand, as has been pointed out, under the law of Delaware, a sale of all of the assets of the affiliated companies to a new company could be accomplished without the necessity for affording stockholders opposing the sale any privilege of receiving in cash an appraised value of their shares. Although the law of New York, under which National Investors Corporation had been created, granted to stockholders opposing the sale of all of the assets of their corporation a right to an appraisal, it would be unlikely that stockholders of National Investors Corporation would oppose a plan which accorded to them favorable treatment.[217]

Accordingly, the plan provided for the sale of all of the assets of the four companies to a new company known as National Investors Corporation, in consideration of the issuance of the securities of the new company. The plan stipulated that the assent of the holders of two-thirds of the outstanding securities of each of the companies was required to sanction the sale of the assets of the companies. That the procedure was consciously formulated to eliminate any right of dissenting stockholders in the affiliated companies to demand an appraisal value in cash of their securities, was conceded by Mr. Presley: [218]

Q. What were the mechanics of the plan? You had National, a New York Corporation, and you had Second, Third, and Fourth, Delaware Corporations, and just how would the mechanics be worked out, so as to form the new company with all participations of all stockholders thrown into the new company?

A. It was based on a theory of the sale of assets.

Q. Rather than a merger?

A. Yes, and primarily I think because on a sale of assets a two-thirds vote would bind the minority.

Q. You mean to bind them to the point where they couldn't have an appraisal?

A. That was our understanding under the laws of Delaware, whereas in National regardless of the vote of approval, there was a right of appraisal under the laws of the State of New York.

Q. Did you feel that the minority stockholders should have the right of appraisal, or what was your feeling on that?

A. I personally didn't feel that way.

Q. Why?

A. In the first place, we decided that we would not make a deal with anyone after that plan went out, and we would let it be defeated first, and we weren't going to ask the majority to approve a plan and to ante up for minority interests, and there are so many seeking an unfair price in relation to the majority stockholders——

Q. That is a matter to be determined in the appraisal by judicial proceedings, isn't it? That is what the Delaware law contemplated, and also the New York law?

A. Yes; that is right.

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[217] Consolidated Laws of N. Y., Ch. 59, §§ 20, 21.

[218] Op. cit. supra, note 185, at 4462–3.

Q. Did you have a feeling that those proceedings frequently worked unfairly to the majorities?

A. I really don't know, I had thought perhaps that the right of appraisal might give minorities in Second, Third, and Fourth * * * their full asset value at the expense of the majorities who approved the plan.

Q. You feel then that that [the right to an appraisal] is an unwise statutory provision in the way of actually working out?

A. That there should not be a right of appraisal? Is that the question?

Q. That there should be.

A. I think that where two-thirds of the stockholders vote for a plan that was submitted in good faith by the directors, that the minority interests should not have any advantage over that majority.

Q. You made a conscious attempt to avoid those rights of appraisal?

A. Certainly.

Although the management committee's plan of reorganization of the four companies was approved by the group of stockholders in the affiliated companies which had originally pressed the management to prepare the plan of reorganization, other groups of stockholders, particularly those of Fourth National Investors Corporation, organized protective committees to oppose the plan. The United Business Service of Boston, an independent securities advisory agency, also opposed the plan. As the result, primarily, of the activities of a protective committee for the stockholders of Fourth National Investors Corporation, headed by Thomas E. Brittingham, the plan failed of consummation because of the failure of the management to procure the assent of two-thirds of the holders of the stock of Fourth National Investors Corporation to the sale of its assets to the new company.[219]

Despite its defeat, the management did not cease its effort to consolidate the four companies. By the close of 1936, new pressures were driving the management to effect a consolidation of the companies.

First, the passage of the Revenue Act of 1936, which contained provisions imposing a tax upon undistributed corporate profits,[220] impaired the future value of the warrants of the affiliated companies held by National Investors Corporation. The management's duty to the stockholders of the affiliated companies would clearly be to distribute realized profits in order to avoid the incidence of the tax. On the other hand, the distribution of these profits of the affiliated companies, instead of accumulating them to enhance the asset value of their shares, would tend to destroy the possibility of the warrants acquiring a value in the future. And since the warrants of the affiliated companies constituted a substantial portion of the assets of National Investors Corporation, any impairment of their value would seriously affect the value of the common stock and warrants of National Investors Corporation. This conflict in interest thus generated between National Investors Corporation and its affiliated companies was summarized by Mr. Presley as follows:[221]

It can also be argued that with this undistributed profit still in existence, that the warrants * * * may be worth absolutely nothing, because the

[219] Id., at 4464 and 4479.

[220] Revenue Act of 1936, §§ 13, 14.

[221] Op. cit. supra, note 185, at 4549–50.

payment of capital profits realized to the stockholder would * * * impair the warrants. They would be destroyed, and there would be no chance of any enhancement in the value of the common stock. That puts the directors of Fourth National in an extremely serious position. If they pay out their undistributed profits, thus avoiding a tax of at least 27 percent maximum to the stockholders and National Investors Corporation takes the position that that would destroy the warrants there is apt to be an action brought by the stockholders and directors of National against the directors of Fourth National and on the other hand if the directors do not pass on these realized profits to the stockholders thus circumventing the tax, they are in serious trouble with their own common stockholders.

The consolidation of the four companies into a single open-end company under a plan which would eliminate the warrants would, of course, terminate this conflict of interests. And the qualification of the new company as a "mutual investment company," as defined in Section 48 (e) of the Revenue Act of 1936,[222] would exempt it from the incidence of the undistributed corporate profits tax.[223] Obviously the possible adverse effect of the new undistributed profits tax upon the future value of the warrants would furnish some incentive to the stockholders of National Investors Corporation to agree to a plan of consolidation, particularly in view of the fact that warrant holders would apparently have no legal right to restrain a valid declaration of dividends upon the issuing corporation's shares.[224] On the other hand, a consolidation which did not provide for favorable treatment of the warrants in the affiliated companies held by National Investors Corporation would be resisted by the stockholders of National Investors Corporation.

Second, the threat of a shift in control of National Investors Corporation which might terminate Mr. Presley's continued management of the group of companies became accentuated early in 1936 by the purchase by Hayden, Stone & Co. for the account of The Adams Express Company (an investment company in the management of which Hayden, Stone & Co. exerts a substantial influence)[225] of the large block of the common stock of National Investors Corporation held by Atlas Corporation. An attempt earlier in the same year by Mr. Presley to acquire the block of National Investors Corporation common stock held by Atlas Corporation had been unsuccessful.[226] Following the purchase by The Adams Express Company of Atlas Corporation's holdings of National Investors Corporation's common stock, it was Mr. Presley's understanding that Hayden, Stone & Co. had also negotiated for the purchase of the block of the same stock held by the liquidators of the Guardian Detroit system of banks and security affiliates, and for a small block of National Investors Corporation common stock held by Shawmut Association of Boston, one of the original distributors of the securities of National Investors Corporation. As Mr. Presley testified, if The Adams Express Company succeeded in purchasing the block of National Investors Corporation stock held by the liquidators of Guardian Detroit Company,

[222] See Part Two (House Doc. No. 70, 76th Cong.), Ch. II, note 74, p. 84, for the definition of a "mutual investment company" under Section 48 (e) of the Revenue Act of 1936.

[223] Revenue Act of 1936, §§ 13 (a) (3) ; 27.

[224] Garner & Forsythe, "Stock Purchase Warrants & Rights" (1931), 4 So. Cal. Law Rev. 375, 386; cf. *Gay* v. *Burgess Mills*, 30 R. I. 231, 74 Atl. 714 (1909).

[225] See Part Two (House Doc. No. 70, 76th Cong.), Ch. V, p. 425.

[226] Op. cit. supra, note 185, at 4542–3.

The Adams Express Company would have practical control of National Investors Corporation and its affiliated companies. And although Steele Mitchell, a director of The Adams Express Company and a member of the firm of Hayden, Stone & Co., denied that The Adams Express Company had attempted to acquire the block of stock held by the liquidators of the Guardian Detroit companies in an effort to acquire control of the National Investors Corporation group, The Adams Express Company, nevertheless, demanded and received representation on the directorate of National Investors Corporation. Jesse Van Alstyne, a director of Otis Elevator Company, was elected to National Investors Corporation's board of directors as the representative of The Adams Express Company.[227]

An immediate consolidation of the companies, in addition to its taxation advantages, would remove the threat to Mr. Presley's control represented by the appearance of The Adams Express Company as a large stockholder in National Investors Corporation. But as Mr. Mitchell testified, it was doubtful that The Adams Express Company would assent to any plan unless it received "a pretty fair compensation to relinquish the speculative values" in its common stock holdings of National Investors Corporation.[228] And, as has been stated, the value of the common stock of National Investors Corporation depended to a substantial extent upon the values to be allocated, in the plan of consolidation, to its holdings of the warrants of the affiliated companies. The liquidators of the Guardian Detroit companies, which held a large block of National Investors Corporation common stock, had indicated that they would refuse to approve any plan which did not allocate, in terms of a new company's shares, the sum of $4 for each existing warrant of Fourth National Investors Corporation, substantially all of which were owned by National Investors Corporation. It will be remembered that the defeated plan of 1934 had placed a value of only $2 on each Fourth National Investors Corporation warrant. Mr. Presley, in his tentative calculation made in October 1936 with reference to a new plan, had allocated only $1.75 per Fourth National Investors Corporation warrant, a figure which had the approval of James E. Brittingham, the head of the protective committee for Fourth National Investors Corporation stockholders whose efforts had defeated the 1934 plan.[229]

However, the plan of reorganization, as finally promulgated in December 1936 and approved by the requisite vote of the shareholders of the various companies in March 1937, allocated a value of $3 to the warrants of Fourth National Investors Corporation. Like its 1934 predecessor, the new plan provided for the sale of all of the assets of each of the National Investors corporations to a new open-end company known as National Investors Corporation whose stock was to have an initial asset value of $10 a share and which was to qualify as a mutual investment company under the Revenue Act of 1936.[230] Mr. Presley was to become president of the new company at an estimated remuneration for the year 1937 of $32,400.[231]

[227] Id., at 4543–4, 4547, 4587–8.
[228] Id., at 4591.
[229] Id., at 4482, 4498.
[230] Securities Registration Statement, National Investors Corporation, Form A–1, File No. 2–3505–1–1, Exhibit H.
[231] Id., p. 49.

In its allocation of asset values in terms of the new company's shares distributable to the various security holders of the existing companies, the plan, like its 1934 prototype, was favorable to the common stock and warrant holders of National Investors Corporation.

The common stock of National Investors Corporation which had an asset value on November 30, 1936, of 93 cents a share, received, under the plan, securities of the new company having an asset value of $4 per share exchanged, an increase in assets of over $3 a share. It will be recalled that under the 1934 plan the common stock of National Investors Corporation had been allocated an increase in asset value of only $1.90. Further, the $4 allocated under the 1937 plan to the common stock of National Investors Corporation exceeded its then market value by 75 cents. The value allocated to the common stock of National Investors Corporation under the plan would obviously satisfy the liquidators of the Guardian Detroit system of companies since it would enable them to dispose of their holding of National Investors Corporation common stock at a price in excess of its market and asset value. Presumably, the plan was also acceptable to The Adams Express Company which had acquired most of its holdings of National Investors Corporation common stock from Atlas Corporation at a price of $2 a share. As a result of the plan, The Adams Express Company derived a 100% profit on its investment.[232]

Similarly, the warrants of National Investors Corporation were exchanged for shares in the new company having an asset value of one dollar. To create these asset values for the common stock and warrants of National Investors Corporation, a dilution of the asset value of the preferred stocks of National and Second National Investors Corporation and of the capital stocks of Third and Fourth National Investors Corporations in the aggregate amount of approximately $2,880,000, was effected by the plan.[233] Table 23 [234] indicates the exist-

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[232] Op. cit. supra, note 185, at 4542.

[233] This figure is computed as follows:

Asset gain at expense of National Investors Corporation preferred stockholders		$245,751
Asset gain at expense of Second National Investors Corporation preferred stockholders:		
On National Investors Corporation's holdings of 100,000 Second National Investors Corporation common		550,000
On National Investors Corporation's holdings of 200,000 Second National Investors Corporation warrants		1,000
Asset gain at expense of Third National Investors Corporation stockholders on National Investors Corporation's holdings of 101,200 warrants	$151,800	
Less National Investors Corporation's loss in assets on its holdings of 21,300 shares of Third National Investors Corporation stock	24,921	
		126,879
Asset gain at expense of Fourth National Investors Corporation stockholders on National Investors Corporation holdings of 685,000 warrants	2,055,000	
Less asset loss on National Investors Corporation holdings of 21,700 shares of Fourth National Investors Corporation stock	97,150	
		1,957,850
		2,881,480

[234] The figures contained in this table were derived from the proxy solicitation literature prepared and circulated by the management and filed with the Commission pursuant to Sec. 14 of the Securities Exchange Act of 1934 (File Nos. 11–265–1 [National Investors Corporation]; 11–266–1 [Second National Investors Corporation]; 11–267–1 [Third National Investors Corporation]; and 11–230–1 [Fourth National Investors Corporation]).

ing asset and market values of the various securities involved in the plan and the treatment accorded to such securities by the plan. In addition to the securities in the new company, the preferred stock of National Investors Corporation and Second National Investors Corporation received a cash payment of arrearages in dividends. The value of these dividends is added to the asset value of the new company's shares allocated to these preferred stocks to determine the total asset values allotted to them.

TABLE 23.—*Plan of reorganization of National Investors Corporation group as at Nov. 30, 1936*

	Number of shares outstanding Nov. 30, 1936 (excluding stock and warrants held in treasury)	Net worth Nov. 30, 1936, used as basis for allocating stock of new company	Liquidating value per share on this basis	Individual market values as at Nov. 30, 1936	Total market value
National Investors Corporation:					
Preferred stock	14,858	$1,954,421.32	$131.54	$101	$1,500,658.00
Common stock	792,519	741,487.55	.936	3¼	2,575,686.75
Warrants	381,336			1⅛	429,003.00
		[a] 2,695,908.87			4,505,347.75
Second National Investors Corporation:					
Preferred stock	82,617	9,845,406.01	119.17	85¾	7,084,407.75
Common stock	300,000			4½	1,350,000.00
Warrants	200,000				
		[b] 9,845,406.01			8,434,407.75
Third National Investors Corporation:					
Common stock	167,276	7,707,378.65	46.076	38½	6,440,126.00
Warrants	130,000			Bid—1 (12/8/36)	130,000.00
		7,707,378.65			6,570,126.00
Fourth National Investors Corporation:					
Common stock	500,000	27,893,484.29	55.787	w/w 45⅜	22,687,500.00
Warrants	1,000,000			Bid—1¼ (10/16/36)	1,250,000.00 (A) (C)
		27,893,484.29			23,937,500.00
		48,142,177.82			43,447,381.50

[a] Before deduction of market value of stocks and warrants held by National Investors Corporation in other three companies of $2,254,688.50, and dividends on preferred stocks accrued to Jan. 13, 1937, for National Investors Corporation and to Dec. 31, 1936, for Second National Investors Corporation of $1,574,935.73:

Net worth Nov. 30, 1936, used as basis for allocating stock of new company	Total market value	Total number of new company shares issuable	Asset value in terms of new company shares (per present class of stock or warrants)
$3,829,624.23	$2,458,182.03	482,731	$4,827,136.41
44,312,553.59	40,898,199.47	4,431,238	44,312,553.59

Source: See note 234 in text.

TABLE 23.—*Plan of reorganization of National Investors Corporation group as at Nov. 30, 1936*—Continued

	Number of new company shares issuable for each present share or warrant	Combined asset value of new company shares and approximate cash dividend for each present share of preferred stock	Total number of new company shares issuable	Asset value in terms of new company shares (per present class of stock or warrants)
National Investors Corporation:				
Preferred stock	[b] $13.69 10.13	$13.69 101.31 } $115.00	150,526	$1,505,260.00
Common stock	.4007	4.007	317,562	3,175,620.00
Warrants	.1007	1.007	38,400	384,000.00
			506,488	5,064,880.00
Second National Investors Corporation:				
Preferred stock	[b] $16.60 8.258,547	99,185.47	682,296	6,822,960.00
Common stock	.55	5.50	165,000	1,650,000.00
Warrants	.0005	.005	100	1,000.00
			847,396	8,473,960.00
Third National Investors Corporation:				
Common stock	4.49	$44.91	751,237	7,512,370.00
Warrants	.15	1.50	19,500	195,000.00
			770,737	7,707,370.00
Fourth National Investors Corporation:				
Common stock	4.97(B)	$49.78 } $51.28	2,489,348	24,893,480.00
Warrants	(A) .15(5.12) (C) .30	1.50 3.00	(A) 75,000 (C) 225,000	750,000.00 2,250,000.00
			2,789,348	27,893,480.00
			4,913,969	49,139,690.00

[b] Approximate cash dividend on preferred stock.
(A) Assenting attached warrant for one-half share.
(B) Stock per share with warrant for one-half share attached being unit in which stock of this corporation is traded on the New York Stock Exchange.
(C) Assenting warrant for one share (detached warrants).

As the table indicates, the plan required preferred stockholders of National Investors Corporation to sacrifice approximately $16 a share in asset values, preferred stockholders of Second National Investors Corporation to relinquish $20 in asset values, stockholders of Third National Investors Corporation to relinquish approximately $1 in asset value, and stockholders of Fourth National Investors Corporation to cede $4.50 in asset values. These losses were allocated to the negative asset value common stock of Second National Investors Corporation, 100,000 shares of which were owned by National Investors Corporation, and to the warrants of Second, Third, and Fourth National Investors Corporations, substantially all of which were owned by National Investors Corporation. Although the asset value of the stocks of the affiliated companies had increased, between 1934 and 1936, to a point nearer the exercise price of the warrants of the affiliated companies held by National Investors Corporation, con-

comitantly the period in which the warrants could be exercised had become shorter. And, as has been stated, the existence of the federal undistributed profits tax tended to impair the future value of these warrants by inhibiting any accumulation of profits to enhance the asset value of the stock of the affiliated companies and thus of their warrants.

It is unnecessary to determine whether or not this plan was fair or unfair in view of all of the circumstances. It must be pointed out, however, that the plan was prepared solely by the managements of the four companies. And although these managements presumably acted in good faith in the preparation of the plan, several of the members of the directorates of the four companies were conceivably not without some bias in favor of some or all of the various classes of the securities of National Investors Corporation. In 1936, at least six directors of National Investors Corporation and its affiliated companies either held[235] or represented substantial blocks of the securities of National Investors Corporation or otherwise may have been biased in favor of its security holders. George F. Rand and Charles H. Diefendorf, two of these directors, were also officers of The Marine Trust Company of Buffalo, which, as has been stated, was a substantial holder of the warrants of National Investors Corporation. Alger Shelden, another director, was a substantial holder of the preferred stock of National Investors Corporation.[236] Jesse H. Van Alstyne, another director of National Investors Corporation, had been elected to his position as the representative of The Adams Express Company, which held a substantial block of the common stock of National Investors Corporation. Robert O. Lord, still another director of National Investors Corporation, had been president of the insolvent Guardian Detroit Bank of Detroit which, together with its security affiliate, Guardian Detroit Company (which in 1936 was in the process of liquidation), held substantial blocks of the common stock of National Investors Corporation. Finally, the conceivable bias of Mr. Presley in favor of the securities of National Investors Corporation has already been pointed out.

Despite the fact that the dilution in the asset values of the shares of the affiliated companies under the 1937 plan exceeded that under the defeated 1934 plan, the record does not indicate that any organized stockholder opposition to the 1937 plan developed. Mr. Brittingham, whose protective committee had been in a large measure responsible for the defeat of the 1934 plan, had sold at a profit all of his family's holdings of the stock of Fourth National Investors Cor-

[235] The solicitation literature used in connection with the successful 1937 plan of consolidation revealed that the directors of the four companies and partnerships in which they were partners and corporations of which they were directors and officers, held the following securities of the National Investors Corporation group of companies:

	Preferred stock	Common stock	Warrants
National Investors Corporation	1,100	5,650	21,078
Second National Investors Corporation	2,321	1,500	
Third National Investors Corporation		3,903	2,415
Fourth National Investors Corporation		*13,285	

*Each share has a warrant attached for one-half share.

[236] Op. cit. supra, note 185, at 4460.

poration in 1936 to Hayden, Stone & Co.[237] It may be inferred that the cessation of Mr. Brittingham's pecuniary interest in the National Investors Corporation companies also terminated his activities in behalf of the shareholders of such companies, particularly in view of the fact that his successful opposition to the 1934 plan had been financed largely at his own expense.[238]

b. Sale of Assets of Granger Trading Corporation to Yosemite Holding Corporation

Elsewhere in this chapter [239] there has been described the means by which Yosemite Holding Corporation, then dominated by Wallace Groves, had, in April 1932, acquired control of Granger Trading Corporation. Briefly Yosemite Holding Corporation had purchased from Sulzbacher, Granger & Company and members of the Granger family and from Granger Trading Corporation itself almost a majority of the stock of Granger Trading Corporation. Yosemite Holding Corporation had obtained the cooperation of Sulzbacher, Granger & Company in acquiring control of Granger Trading Corporation by purchasing that sponsoring firm's unprofitable management contract with Granger Trading Corporation.

The objective of Mr. Groves and of Yosemite Holding Corporation was to acquire the assets of Granger Trading Corporation at a total price less than the actual worth of the assets. But Yosemite Holding Corporation had acquired control of Granger Trading Corporation by paying asset value for its holdings. In fact, to the extent of the payment made by Yosemite Holding Corporation for the management contract held by Sulzbacher, Granger & Company, it had suffered an actual loss in acquiring control of Granger Trading Corporation. Of necessity, therefore, any profit to be realized by Yosemite Holding Corporation on its venture was to be realized at the expense of the minority stockholders of Granger Trading Corporation.

On May 2, 1932, a "plan and agreement of reorganization" [240] was entered into between Granger Trading Corporation and Yosemite Holding Corporation, both of which were controlled by Mr. Groves. By the terms of this "plan" Granger Trading Corporation agreed to convey all of its assets to Yosemite Holding Corporation in return for the issuance of 2,701¾ shares of the preferred and 10,807 shares of the common stock of Yosemite Holding Corporation. The reorganization plan contemplated the subsequent dissolution and liquidation of Granger Trading Corporation and provided that the Yosemite Holding Corporation stock transferred to Granger Trading Corporation be distributed among the latter's stockholders, with the exception of Yosemite Holding Corporation to the extent of its then holdings of Granger Trading Corporation stock. However, Yosemite Holding Corporation would share in the distribution of Granger Trading Corporation's assets as to any shares of Granger Trading Corporation which Yosemite Holding Corporation acquired after the date of the plan of reorganization.

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[237] Id., at 4487.

[238] Id., at 4469.

[239] See supra, pp. 1302–3, and Ch. II of this part of the report, pp. 181–226.

[240] Public Examination, The Equity Corporation, Commission's Exhibit No. 107.

The true nature of this transaction is illustrated by the consideration paid by Yosemite Holding Corporation to the minority stockholders of Granger Trading Corporation for virtually all of the assets of Granger Trading Corporation belonging to these minority interests. On the date of the promulgation of the plan, the assets of Granger Trading Corporation consisted almost entirely of cash, and the asset value per share of the corporation's stock was $12.22.[241] On the ultimate dissolution of Granger Trading Corporation, its minority stockholders received as their pro rata share of its assets, approximately $2,100 in cash, 2,412 shares of Yosemite Holding Corporation preferred stock, and 9,649 shares of Yosemite Holding Corporation common stock. The two blocks of Yosemite Holding Corporation stock possessed an aggregate asset value of $5,547.60.[242] The minority stockholders of Granger Trading Corporation thus received assets worth approximately $7,700, or about 69 cents a share of their 11,155 shares of Granger Trading Corporation stock. As a result of the plan, the minority stockholders of Granger Trading Corporation suffered a loss of virtually the entire asset value of their stock.

On May 3, 1932, the day after the date of the reorganization agreement, the plan was proposed to the board of directors of Granger Trading Corporation.[243] On the same day the board of directors of Granger Trading Corporation, dominated by Mr. Groves' nominees, approved the offer and recommended that it be accepted by the stockholders.[244] When this action was taken by the two corporations, Messrs. Groves, Brophy, and Warriner, three of the seven directors of Granger Trading Corporation, were at the same time directors of Yosemite Holding Corporation.[245]

After the board of directors of Granger Trading Corporation approved the plan, the consent of the stockholders to the sale of assets had to be obtained. Under the Delaware law applicable to the situation, a sale of assets could be consummated on the vote of a majority of the outstanding voting stock. Inasmuch as Yosemite Holding Corporation already held a majority of the outstanding stock of Granger Trading Corporation, there could be no doubt as to the outcome of the vote.

On May 25, 1932, less than a month after the plan was first proposed, the stockholders of Granger Trading Corporation voted in favor of the transaction at a meeting called for that purpose.[246] Except for the possibility of resort to legal proceedings, minority holders could do nothing in opposition. In fact, they did not even have a right to claim payment of the appraised value for the Delaware

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[241] See supra, pp. 1302–3.

[242] Yosemite Holding Corporation common stock had no asset value. The asset value of Yosemite Holding Corporation's preferred stock was $2.30 a share based on the underlying asset value of its holdings of a majority of the negative asset value common stock of Chain & General Equities, Inc. (op. cit. supra, note 240, Commission's Exhibit No. 843). Further, the Yosemite Holding Corporation's preference stock had no quoted market value. The market price of Yosemite Holding Corporation's common stock in August and September 1932 ranged between ½ and 1½.

[243] Id., at 2272.

[244] Id., at 2275.

[245] Derived from supplementary information supplied the Commission for The Equity Corporation.

[246] Ibid.

statute does not provide a right of appraisal in the case of a sale of assets.[247]

Two months later, on July 25, 1932, a special meeting of the board of directors was called to consider dissolution of Granger Trading Corporation. The directors determined upon dissolution and called a stockholders' meeting to approve the decision. The reason stated for dissolution was that Granger Trading Corporation's assets consisted solely of the Yosemite Holding Corporation's preferred and common stock received at the time of the sale of its assets, and about $2,300 in cash, representing a dividend on the Yosemite Holding Corporation preferred stock.[248] The Delaware law required a vote of two-thirds of the stockholders having voting power to effect a dissolution.

The meeting was held on August 29, 1932, and the stockholders, with Yosemite Holding Corporation voting 53% of the outstanding stock, gave their consent. Distribution of Granger Trading Corporation's assets was then made in accordance with the plan of reorganization under which Granger Trading Corporation sold its assets to Yosemite Holding Corporation. Stockholders of Granger Trading Corporation, other than Yosemite Holding Corporation, were to receive their pro rata shares of the Yosemite Holding Corporation preferred and common stock that comprised the assets of Granger Trading Corporation.

Yet, it was but seven months later, at the end of March 1933, that these former stockholders of Granger Trading Corporation, now holders of Yosemite Holding Corporation stock by virtue of the dissolution of Granger Trading Corporation, received the first offer of The Equity Corporation to accept The Equity Corporation's securities in exchange for their Yosemite Holding Corporation shares. Indeed, many of them had not yet turned in their Granger Trading Corporation stock, and circulars were sent them as stockholders of Granger Trading Corporation.[249] And, at the beginning of the following year, those who had not accepted the exchange offers were eliminated by the subsequent dissolution of Yosemite Holding Corporation.

Unquestionably, the plan of reorganization previously described was drafted by the dominant group. It was signed for Yosemite Holding Corporation by C. B. Ewart, the president of the company and a nominee of Mr. Groves, and for Granger Trading Corporation by Mr. Groves, the moving spirit in the entire transaction.[250] This instrument fixed the participation which minority stockholders would eventually receive in Yosemite Holding Corporation.

The conflicting interests and obligations of the dominant group are apparent. As representatives of Yosemite Holding Corporation, there would be an obligation to obtain the most favorable bargain to Yosemite Holding Corporation stockholders. At the same time, there would be a duty as representatives of Granger Trading Corporation to achieve the most favorable bargain for Granger Trading

[247] See this section, supra, pp. 1421–2.

[248] Derived from supplementary information supplied the Commission for The Equity Corporation.

[249] Op. cit. supra, note 240, Commission's Exhibit No. 839.

[250] Id., at 808 and Commission's Exhibit No. 107.

Corporation stockholders. Nevertheless, the same interests represented both sides of the bargain. A majority of the board of directors of Granger Trading Corporation voting for the sale of assets in accordance with the terms of the agreement, were elected after Yosemite Holding Corporation had acquired almost a majority of Granger Trading Corporation stock and was, in fact, dominating the management. Yosemite Holding Corporation, controlled by Wallace Groves, voted a majority of the Granger Trading Corporation stock, all that was necessary, in favor of the sale of assets. The terms of the reorganization were fixed and accepted by designees of Wallace Groves. The interests of the minority stockholders of Granger Trading Corporation were left at the disposal of the dominant interest.

Substantially the same board of directors voted for the subsequent dissolution; and, with the aid of the majority of the common stock then held by Yosemite Holding Corporation, the necessary two-thirds were voted for the dissolution. With dissolution accomplished, the course of action planned by the dominant group was completed. The assets of Granger Trading Corporation were in Yosemite Holding Corporation. Granger Trading Corporation stockholders became Yosemite Holding Corporation stockholders.

When Yosemite Holding Corporation's offer to purchase the assets of Granger Trading Corporation came before the board of directors of Granger Trading Corporation for discussion, Jeffrey Granger, former president of the company, who remained a director, did not approve the proposition. He testified:[251]

A. I was present at a meeting where that proposition was discussed.

Q. What did you say when that proposition was put up?

A. I said that I thought that it was a proposition that should be very seriously considered by the board of directors.

Q. Serious in what respect?

A. Serious as a step. Well, any sale of any assets of a corporation to another one is always a serious step.

* * * * * * *

Q. Didn't you have any difficulty with that offer?

A. I had a great deal of difficulty with it.

Q. Did you ever approve it?

A. I never approved it.

The amount of protection that individual directors of a corporation are likely to afford minority holders when outside interests have acquired control is indicated by subsequent events. Mr. Granger testified further:[252]

Q. Did you think that because you didn't agree with it you didn't approve it?

A. I didn't think that it was something that I could resolve myself. I felt that that was something for the controlling interests to determine. They were then responsible for the conduct of the corporation, and I felt that they were the ones really to pass upon the advisability of any such offer, but I did point out in the meeting that before this thing should be consummated, the directors should give it the closest attention and to determine whether or not it was for the best interests of the stockholders.

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[251] Id., at 2272–4.

[252] Id., at 2274–5.

Now, I was one out of six directors, and I presume that the Board of Directors did give it that thought and attention, and that they finally came to the conclusion that that was for the best interests of the stockholders.

* * * * * * *

Q. Now, you knew that any speech that you were making at that meeting was being made to nominees of Mr. Groves * * * and those were his people that he picked, isn't that so?

A. I knew that he picked that Board of Directors, but I didn't know that they would not exercise their best judgment in regard to what was best for the stockholders.

That the old management, perhaps in return for the price paid for their stock and other interests in Granger Trading Corporation,[253] lent the Groves' interests their passive assistance in the effectuation of the reorganization plan, may be inferred from the record. Although Mr. Granger "never approved" the sale of assets, he did not vote against acceptance of it. In fact, he testified that he was not present at the meeting of the board of directors when formal action was taken upon the offer.[254] Thereafter, proxies were solicited for approval of the sale of assets by stockholders.[255] It seems that although Yosemite Holding Corporation had sufficient stock to approve the sale, it desired nevertheless to obtain as much independent approval as possible. The purpose may have been to minimize any chance of legal action by minority holders to enjoin or set aside the sale. In any event, one of the named proxies was Jeffrey Granger, despite the fact that he had not approved the plan. Mr. Granger testified that his name was used without his authority:[256]

Q. * * * Were you designated one of the proxies in the proxy that was sent out?

A. My name was on the proxy, but it was not done with my authorization.

Q. Did you object to it?

A. I certainly did. That was sent out without my consent and I certainly did object to it.

And Mr. Granger testified that he realized that the appearance of his name on the proxy might cause stockholders of Granger Trading Corporation to believe he approved the plan. But he took no steps to remove this impression. Mr. Granger's testimony on this phase is as follows:[257]

Q. On that score, did you write to the stockholders and say, "My name appears on this proxy, but it is not only without my consent, but against my wishes." Did you, Mr. Granger?

A. I considered that, but I didn't think it was advisable.

* * * * * * *

Because there were three or four other people there and, as a matter of fact, I didn't exercise any of those proxies. I didn't go to the meeting and I didn't exercise any of them.

Q. Isn't it a fact that a stockholder executing that proxy, seeing your name there, would have the right to assume that you approved this transaction and

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[253] See supra, pp. 1302–3.

[254] Op. cit. supra, note 240, at 2272–4.

[255] Id., at 2284, 2290.

[256] Id., at 2290.

[257] Id., at 2290–1.

the sale of all the assets of the trust in exchange for Yosemite Holding Company stock and the truth is that you did not want your name there?

A. That is true.

Mr. Granger explained that he made no attempt to communicate with stockholders because he did not possess a stockholders' list:[258]

Q. You can visualize, can you not, that stockholders who had purchased that stock originally, in reliance upon the fact that Sulzbacher, Granger & Company were going to manage that trust and seeing your name in the proxy, would have the right to assume you approved it; isn't that so?

A. That is true, but there was a physical reason. I did not have control of the books and I did not have a list of the stockholders, and it was impossible for me to send out anything to them.

Q. You knew they were clients of yours?

A. I knew, maybe, some of them. Anybody that asked me about it, I told them I neither approved nor disapproved of it. I gave them the facts.

But no explanation was advanced by Mr. Granger as to why he, as a director, did not have access to the books of the corporation. Moreover, he testified that Granger Trading Corporation was organized at the request of customers of Sulzbacher, Granger & Company and that virtually all of its stockholders were personal clients. It would seem that many stockholders could have been reached without a stockholders' list.

c. Consolidation of United Founders Corporation and Subsidiaries to Form American General Corporation

A frequent statutory safeguard erected by the states against possible inequities to stockholders as the result of a merger or consolidation is a requirement for a vote of approval by each and every class of stockholders who may be affected by a plan of merger or consolidation irrespective of whether or not any of the various classes of securities normally have voting rights. However, even the elimination of this safeguard may be accomplished by an ingenious management. The consolidation into American General Corporation of United Founders Corporation and its subsidiaries in November 1935 is illustrative of the inadequacy of these statutory provisions as against a management determined to bend to its own purposes legal and corporate devices which will substantially enable it to vitiate such provisions.

As has been recounted earlier in this chapter,[259] The Equity Corporation in 1933 acquired control of all of the Class A stock of United Founders Corporation, an investment company which controlled 78% of the voting securities of American Founders Corporation, which in turn controlled American and Continental Corporation, American & General Securities Corporation, International Securities Corporation of America, Second International Securities Corporation, and United States & British International Co., Ltd. The control of all of these companies by American Founders Corporation was largely predicated upon its ownership of their common stocks. Substantial blocks of the preferred stocks of American

[258] Id., at 2291–2.

[259] See supra, pp. 1138–42.

Founders Corporation's leverage investment company subsidiaries were outstanding in the hands of the public.[260]

It will be recalled that the capitalization of United Founders Corporation consisted of 9,000,000 shares of common stock and 1,000,000 shares of Class A stock. Although the Class A stock had only a nominal asset value in 1933 and thereafter,[261] it was at all times entitled to one-half as many votes for all corporate purposes as was possessed by the common stock which was entitled to one vote a share. In other words, the Class A shares were entitled to 4,500,000 votes for any corporate purpose, a voting power equivalent to one-third of the total voting power of all of the company's outstanding securities.[262] Originally this Class A stock had been issued to Louis H. Seagrave, Christopher F. Coombs, and Frank B. Erwin, the sponsors of the United Founders Corporation group of companies.[263] It was from these individuals that The Equity Corporation acquired the Class A stock of United Founders Corporation by the payment of $994,279.73 and 260,150 shares of the common stock of The Equity Corporation, a total consideration vastly in excess of the asset and market value of the Class A stock.[264]

The right to vote the Class A stock, however, placed The Equity Corporation in effective control of United Founders Corporation and its subsidiaries. It enabled The Equity Corporation to place its nominees on the directorate of United Founders Corporation.[265]

Finally, the purchase of the Class A stock, by eliminating the possible opposition of the former management of the United Founders Corporation system of companies, placed The Equity Corporation in a strategic position to effectuate exchange offers of its shares for the shares of United Founders Corporation and its subsidiary companies and the ultimate consolidation of such companies.

Between 1933 and September 1935, The Equity Corporation, as the result of all of its exchange offers and purchases, acquired 1,213,881 shares of the common stock of United Founders Corporation, 15,386 shares of the 7% preferred stock, and 39,381 shares of the 6% preferred stock of American Founders Corporation, and 23,081 shares of the common stock of American and Continental Corporation.[266] As will be seen, prior to the consolidation of the United Founders Corporation group of companies in November 1935, these securities and all of the Class A stock of United Founders Corporation were turned over to United Founders Corporation in exchange for 6,000,000 shares of the latter's common stock. The reasons for this transaction will be discussed later.

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[260] Op. cit. supra, note 240, Commission's Exhibit No. 843.

[261] The Class A stock was entitled on liquidation of the corporation to only 1/297 of the net corporate assets. In 1933, the Class A stock's asset value was approximately $48,000. The asset value of the common stock was approximately $14,000,000 (id., Commission's Exhibit No. 797).

[262] Id., at 8546 and Commission's Exhibit No. 745 (pp. 7–8).

[263] Id., at 8546 and Commission's Exhibits Nos. 751, 752.

[264] See supra, pp. 1138–42, and the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), Pt. VII, p. 219.

[265] Op. cit. supra, note 240, Commission's Exhibit No. 822.

[266] Id., Commission's Exhibits Nos. 128, 784, 829, 839, 840, 843, 844, 1183; see the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), Pt. VII, p. 293.

From the inception of its interest in United Founders Corporation, the ultimate purpose of The Equity Corporation had been to merge or consolidate the companies comprising the United Founders Corporation group. By September 1935 a concrete plan of consolidation had apparently been formulated by The Equity Corporation. This plan in essence provided for the organization of a new corporation known as American General Corporation which was to have a capital structure consisting of preferred and common stocks and which was to acquire the assets of the United Founders Corporation system of companies and also those of Reliance Management Corporation, a corporation not a member of the United Founders Corporation group but then controlled by The Equity Corporation, in consideration of the issuance of the new company's shares to the stockholders of the absorbed companies. This plan was adopted rather than a plan to absorb all the companies directly into The Equity Corporation because, as Mr. Milton testified, the management of The Equity Corporation did not desire to complicate its capital structure by the introduction therein of a bond issue of a type then in the capital structure of Reliance Management Corporation.[267] However, the plan adopted also had the advantage of avoiding a dilution in the control of The Equity Corporation held by its largest stockholders, David Milton and Ellery Huntington. In September 1935 these individuals held approximately 20% of the voting securities of The Equity Corporation, a block of shares sufficient to insure effective control of the corporation.[268] If the United Founders Corporation group of investment companies were consolidated with The Equity Corporation directly in consideration of the issuance of the latter corporation's securities [269] to the minority stockholders of the absorbed companies (who in most cases owned a majority of the senior securities of the various United Founders Corporation companies), a substantial decrease in the percentage of the voting securities of The Equity Corporation held by Mr. Milton and Mr. Huntington would have occurred.

The plan of consolidation of the United Founders Corporation group of companies (and of Reliance Management Corporation), as ultimately proposed and consummated, involved a drastic readjustment of the contractual rights of the preferred stockholders of the subsidiaries of United Founders Corporation. In some cases the dividend and liquidating preferences of such stocks were greatly decreased.[270] In addition accrued unpaid dividends, totaling in the

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[267] Op. cit. supra, note 240, at 8517.

[268] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. V, p. 431.

[269] Both the preferred and common stocks of The Equity Corporation were entitled to one vote a share. See supra, p. 1040.

[270] For example, the holders of the 6% and 7% preferred stock of American Founders Corporation which had a dividend priority of $3 and $3.50 a share per annum, respectively, were awarded a preferred stock of American General Corporation having an annual dividend priority of $2.40 a share. The preferred stock of International Securities Corporation of America, Second International Securities Corporation, and United States & British International Co., Ltd., received similar treatment. The preferred stock of International Securities Corporation of America which was entitled on liquidation of the company to a prior claim against the corporate assets to the extent of $100 a share, received preferred stock of American General Corporation entitled to a preference of only $60 a share. (See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), Pt. VII, p. 325.)

aggregate $3,900,000 in November 1935, upon the preferred stock of the subsidiaries of United Founders Corporation were eliminated by the plans.[271] Preferred stockholders under the plan were, moreover, to suffer an aggregate loss of asset values of approximately $200,000.[272] In other aspects the plan resulted in substantial changes in the rights of the stockholders of the United Founders Corporation companies. For example, the charter of International Securities Corporation of America provided that the corporation would make no loans which were not secured by collateral having a value at least equivalent to 125% of the amount loaned.[273] The board of directors of American General Corporation, however, was authorized to lend funds without security.[274]

Whether these sacrifices upon the part of the preferred stockholders of the United Founders Corporation companies provided for by the plan were offset by the advantages of reduced administrative expense which might be a product of the simplification of the previously pyramided structure of companies in the United Founders Corporation group, need not be determined here. Of importance, however, is the fact that the plan was devised and executed only by The Equity Corporation. Minority stockholders had no independent representation in the negotiation of the terms of this plan which so sharply readjusted their security interest in their corporations. And in the preparation of the plan The Equity Corporation, as a holder of the equity securities of United Founders Corporation, was clearly in a position antagonistic to the senior security holders of the subsidiaries of United Founders Corporation. The Equity Corporation's investment in the system of companies, as will be seen later, consisted largely of its holdings of the stock of United Founders Corporation. In turn, United Founders Corporation's holdings of the securities of its subsidiary companies were confined largely to their equity securities, which in several instances had little or no asset value.[275]

The dominant position in the United Founders Corporation group of companies held by The Equity Corporation also placed it in a powerful position to remove or to minimize actual or potential obstacles to the effectuation of its plan. One such obstacle, for example, would be the appraisal rights of minority stockholders who might dissent from the plan. Unlike the Delaware statutes, which do not grant to dissenting stockholders a right of appraisal in the event of a sale of all of their corporation's assets, the laws of Maryland, under which all of the United Founders Corporation group of companies, with the exception of American and Continental Cor-

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[271] Id., p. 326.

[272] Op. cit. supra, note 240, Commission's Exhibit No. 775.

[273] Id., Commission's Exhibit No. 860 (pp. 3–4).

[274] Id., Commission's Exhibit No. 862 (p. 5).

[275] On November 22, 1935, the date of the consolidation of the various United Founders Corporation companies into American General Corporation, the common stocks of International Securities Corporation of America and United States & British International Co., Ltd., had no asset value. The Class B common stock of American & General Securities Corporation was likewise without asset value. The shares of Class A common stock of American & General Securities Corporation and the common stock of American Founders Corporation had net asset values of $11.62 and 81 cents a share, respectively. The Class A and Class B stock of Second International Securities Corporation had net asset values of $2.66 and 27 cents a share, respectively (Id., Commission's Exhibit No. 843).

poration, were incorporated, authorize a right of appraisal irrespective of the statutory mode adopted for the amalgamation of corporations.[276] In other words, the Maryland laws offer to corporate managements no choice of any method of uniting the assets of various corporations in a manner which will defeat appraisal rights. As a consequence, the plan for the amalgamation of the assets of the United Founders Corporation companies and of Reliance Management Corporation provided that it be accomplished by means of a statutory consolidation. Although stockholders dissatisfied with the terms of the consolidation plan would have a right to an appraisal of their shares, the Maryland statutes do not require that the stockholders be informed of this right in the solicitation literature used by corporate managements to procure assents to the plan. The Equity Corporation failed to inform the stockholders of the consolidating companies of their right to an appraisal. It is reasonable to infer that the average investor is unfamiliar with the fact that he has a right of appraisal. Even if he has knowledge of this right, it is doubtful if he is aware of the statutory requirements which must be followed to procure the right.[277] Undoubtedly, The Equity Corporation's failure to inform stockholders of their appraisal rights served to force into the plan against their will[278] many investors who, if they had been informed of their appraisal right, would have claimed such right.[279]

Other impediments to the consummation of the consolidation confronted The Equity Corporation. First, the ethical, if not the legal, propriety of consummating a consolidation which would vary radically the interests of minority stockholders whose securities possessed a substantial ownership interest in the assets of the companies involved by means of the vote by a dominant stockholder of a "control" block of securities having little or only a nominal ownership interest in the assets of all the companies affected by the plan, would be questionable. At the date of the consolidation of the various companies in the United Founders Corporation group, the outstanding stocks of the subsidiaries of United Founders Corporation

[276] Md. Code Ann. Art. 23, §§ 35, 36½.

[277] Usually the dissenting stockholder, in order to preserve his appraisal right, must either vote against the plan or register in writing a dissent from the plan. Thereafter, a written demand for payment of the value of the shareholder's shares must be made within a specified time. If such payment is not made by the corporation, the stockholder must apply for an appraisal of the shares in the manner specified by the particular state statute. (Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), Pt. VII, p. 598. See for example, Maryland Code Ann. (Flack Supp. 1935) Art. 23, § 35.)

[278] Normally all stockholders who do not exercise their right to an appraisal of the value of their shares on a merger or consolidation of their companies, must accept the securities allotted to them under the plan if such plan has been approved by the required majority of stockholders and has been filed with the proper state official. (15 Fletcher, *Cyclopedia Corporations* (1932), §§ 7063, 7157.)

[279] Only a small percentage of the stockholders of the various United Founders Corporation companies exercised their right to an appraisal. Stockholders who did not vote in favor of the consolidation as ultimately consummated were entitled to 194,000 shares of preferred and 818,900 shares of common stock of American General Corporation. Stockholders who claimed appraisal and payment would have been entitled to 14,600 shares of preferred stock and 9,400 shares of common stock of American General Corporation (op. cit. supra, note 240, Commission's Exhibits Nos. 812, 843, 1196, 1200, 1201; Securities Registration Statement, Form A-1, The Equity Corporation, prospectus dated April 20. 1937, p. 33).

had, on an unconsolidated basis, a combined asset value of approximately \$42,000,000, of which approximately \$15,000,000, or 35% of the total, represented the asset value of the stocks in these companies held by the public.[280] On the other hand, the Class A stock of United Founders Corporation, the ownership of which constituted substantially all of the voting strength of The Equity Corporation in the United Founders Corporation group of companies, had an asset value of approximately \$48,000. But the Class A stock had a 33⅓% voting power in United Founders Corporation, and the control of that corporation which the Class A stock represented enabled The Equity Corporation to vote all of the controlling blocks of the securities of subsidiary companies held by United Founders Corporation and American Founders Corporation. In fact, The Equity Corporation's control of the Class A stock of United Founders Corporation placed it in a position to vote in excess of two-thirds of the total voting securities [281] of each of the subsidiaries of United Founders Corporation in favor of its plan of con-

[280] The following schedule derived from the figures contained in Commission's Exhibit No. 843 indicates the percentage and the asset value of the shares of the subsidiaries of United Founders Corporation owned by the public in November 1935:

	Outstanding shares November 1935	Total asset value November 1935	Percent of shares held by public	Asset value of public's holdings
American Founders Corporation, 7% preferred	42,379	\$2,732,256	48.7	\$1,330,609
American Founders Corporation, 6% preferred	114,198	7,080,276	48.9	3,462,255
American Founders Corporation, common	8,978,091	7,182,472	15.6	1,120,466
American and Continental Corporation, common	425,000	8,075,000	27.7	2,236,775
American and Continental Corporation, Class A	25,000	475,000	25.0	118,750
American & General Securities Corporation, \$3 preferred	8,530	426,500	99.3	423,515
American & General Securities Corporation, Class A common	500,000	5,810,000	2.3	133,630
American & General Securities Corporation, Class B common	500,000	0	3.5	0
International Securities Corporation of America, 6% preferred	44,736	4,093,344	72.8	2,979,954
International Securities Corporation of America, 6½% preferred	14,714	1,346,331	68.7	924,929
International Securities Corporation of America, Class A common	591,156	0	5.8	0
International Securities Corporation of America, Class B common	600,000	0	3.5	0
Second International Securities Corporation, 6% 1st preferred	23,363	1,291,974	95.5	1,233,835
Second International Securities Corporation, 6½% 2d preferred	20,000	1,220,000	0	0
Second International Securities Corporation, Class A common	308,091	941,476	4.9	46,132
Second International Securities Corporation, Class B common	600,000	162,000	3.0	4,860
United States & British International Co., Ltd., \$3 preferred	29,060	947,356	62.3	590,203
United States & British International Co., Ltd., Class A common	294,358	0	4.0	0
United States & British International Co., Ltd., Class B common	300,000	0	9.5	0
		41,783,985		14,605,913
Percentage of total asset value held by public				34.96%

[281] The preferred stockholders of the subsidiaries of United Founders Corporation were entitled to vote because of dividend defaults. (Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), Pt. VII, p. 319.)

solidation. The combined holdings of The Equity Corporation [282] and of United Founders Corporation and its subsidiaries, particularly American Founders Corporation, in the securities of the various United Founders Corporation companies were as follows: [283]

Name of security	Percent controlled directly or indirectly by The Equity Corporation
American Founders Corporation, 7% preferred	51.3
American Founders Corporation, 6% preferred	51.1
American Founders Corporation, common	84.4
American and Continental Corporation, common	72.3
American and Continental Corporation, Class A	75.0
American & General Securities Corporation, preferred	.7
American & General Securities Corporation, Class A common	97.7
American & General Securities Corporation, Class B common	96.5
International Securities Corporation of America, 6% preferred	27.2
International Securities Corporation of America, 6½% preferred	31.3
International Securities Corporation of America, Class A common	94.2
International Securities Corporation of America, Class B common	96.5
Second International Securities Corporation, 6% 1st preferred	4.5
Second International Securities Corporation, 6% 2d preferred	100.0
Second International Securities Corporation, Class A common	95.1
Second International Securities Corporation, Class B common	97.0
United States & British International Co., Ltd., preferred	37.7
United States & British International Co., Ltd., Class A common	96.0
United States & British International Co., Ltd., Class B common	90.5

Although the use of the direct and indirect voting power, inherent in the control of the Class A stock of United Founders Corporation by The Equity Corporation, as an implement to effect its consolidation plan may not have been illegal, certainly the preponderantly large voting strength which such stock possessed in relation to its ownership interest in the total corporate assets involved in the consolidation, might result in a closer scrutiny of the fairness of the terms of the plan by a court in the event of litigation to restrain the consummation of the plan. And in view of the substantial alteration in the rights of the preferred stockholders of the subsidiaries of United Founders Corporation contemplated by the consolidation plan, it was conceivable that efforts would be made to enjoin its consummation.[284]

As an "integral part of the program" [285] for the consolidation, The Equity Corporation, in September 1935, two months prior to the consolidation, contracted to surrender for retirement to United Founders Corporation its holdings of the Class A stock of the latter corpora-

[282] As a result of its exchange offers and purchases The Equity Corporation itself, by September 1935, had acquired approximately 36% of the 7% preferred and 40% of the 6% preferred stocks of American Founders Corporation and approximately 5% of the common stock of American and Continental Corporation (op. cit. supra, note 240, Commission's Exhibits Nos. 784–A, 829, 839, 840, 843, 844, 1183).

[283] Id., Commission's Exhibit No. 843. The number of outstanding shares are indicated in note 280, supra.

[284] In fact several suits were brought to enjoin the consolidation. These suits, however, were settled by The Equity Corporation on advantageous terms to the litigants (op. cit. supra, note 240, Commission's Exhibits Nos. 829, 858, 859, 1202).

[285] Id., at 8671.

tion.[286] At the same time, however, United Founders Corporation agreed[287] to issue to The Equity Corporation 6,000,000 shares of its authorized but as yet unissued common stock in consideration of the transfer to United Founders Corporation by The Equity Corporation of the preferred and common stocks of subsidiary companies in the United Founders Corporation group (which The Equity Corporation had acquired by exchange offers and by purchases) and 388,436 shares of Reliance Management Corporation, the only nonmember of the United Founders Corporation group which was to be included in the consolidation. Both of these contracts were subject, however, to the approval of the stockholders of United Founders Corporation.

These transactions, if consummated, would involve a loss in asset values to The Equity Corporation of approximately $1,000,000,[288] representing the difference between the asset value of the Class A stock of United Founders Corporation and the securities of the latter's subsidiaries exchanged for the 6,000,000 shares of United Founders Corporation common stock, and the asset value of such 6,000,000 shares. Offsetting advantages, however, would accrue to The Equity Corporation as a result of the transaction. First, The Equity Corporation acquired, in lieu of the Class A stock, which, as has been stated, had only a 1/279 interest in the earnings and assets of United Founders Corporation, 6,000,000 shares of United Founders Corporation common stock which were entitled to a 40% interest in the earnings and assets of United Founders Corporation.[289] Second, these 6,000,000 shares of common stock, upon the ultimate consolidation of United Founders Corporation and its subsidiaries into American General Corporation, were to be exchanged for 600,000 shares of the latter corporation's common stock.[290] Since American General Corporation was a leverage investment company,[291] whereas United Founders Corporation was not, The Equity Corporation in effect had exchanged a nonleverage common stock for a leverage common stock, a distinct advantage in 1935 when all indices pointed to a continuance of a period of rising securities prices.[292] In the third place, the

[286] Id., Commission's Exhibit No. 809.

[287] Id., Commission's Exhibits Nos. 808, 842.

[288] Id., at 8672.

[289] The issuance of 6,000,000 shares of common stock of United Founders Corporation to The Equity Corporation would increase such common stock outstanding to 15,000,000 shares.

[290] Op. cit. supra, note 240, Commission's Exhibit No. 862.

[291] Immediately after the consolidation, American General Corporation possessed assets of approximately $50,000,000 (id., Commission's Exhibit No. 850). The capitalization of American General Corporation consisted of the approximately $20,000,000 of outstanding bonds of Reliance Management Corporation, International Securities Corporation of America, and Second International Securities Corporation, which had been assumed by American General Corporation under the terms of the plan of consolidation, and 8,474 shares of $3 preferred stock, 24,539 shares of $2.50 preferred stock, 91,353 shares of $2 preferred stock, and 1,754,756 shares of common stock (id., Commission's Exhibit No. 852). The preferred stocks of all classes were entitled to a preference in assets on liquidation of $50 a share (id., Commission's Exhibit No. 862). The total liquidating value of the preferred shares was approximately $11,000,000. The common stock of American General Corporation, with an asset value of approximately $19,000,000, thus had the leverage of approximately $31,000,000 of senior securities. Expressing this leverage in another way, a 100% increase in the total corporate assets would result in a 250% increase in the asset value of the common stock. Conversely, with a decline in value of total assets, the leverage would cause a more rapid decline in the asset value of the common stock.

[292] Id., at 8673–4.

transaction would actually result in an increased voting control of United Founders Corporation by The Equity Corporation. The consummation of the transaction would give to The Equity Corporation 6,000,000 shares of United Founders Corporation common stock or 40% of the total of 15,000,000 common shares which would be outstanding. These 6,000,000 shares, augmented by the approximately[293] 1,200,000 shares of United Founders Corporation common stock which it had acquired by exchange offers and purchases, would give to The Equity Corporation an approximately 49% voting control of United Founders Corporation. This 49% voting control was later transmuted under the terms of the plan of consolidation to a 49% interest in the common stock of the consolidated company, American General Corporation. This block of stock was sufficient to insure to The Equity Corporation control of the new company. Prior to the consummation of these transactions with United Founders Corporation, The Equity Corporation had only a 42% voting interest in United Founders Corporation, consisting of the 4,500,000 votes represented by the Class A stock, and approximately 1,200,000 shares of the common stock of United Founders Corporation which it had acquired by exchange offers.

Finally, as has been stated, this exchange of securities between The Equity Corporation and United Founders Corporation, by eliminating the Class A stock of United Founders Corporation avoided any potential attack upon the projected consolidation upon the ground that it had been effected, in large part, by the vote of a security which had only a nominal ownership interest in the total corporate assets affected by the consolidation.

David Milton, the president of The Equity Corporation, conceded in his testimony that the elimination of the Class A stock and the exchange of The Equity Corporation's holdings of the securities of the various subsidiaries of United Founders Corporation for the latter's common stock was "in a business view a necessary part of the merger and consolidation,"[294] but denied that the transaction had been devised to avoid any possible future attack upon the use of the voting power of the Class A stock by The Equity Corporation in order to consummate its own plan of consolidation. Mr. Milton testified:[295]

Q. Of course, Mr. Milton, in connection with getting the reaction of stockholders with respect to an exchange, which, taken by itself may look innocuous to the interest of the stockholders, there would be no objection to casting 4,500,000 votes on shares of stock which had an aggregate asset value of $45,000, but if you took that same value of stock and cast 4,500,000 shares where it involved such a substantial thing as affecting a consolidation of a parent and five or six subsidiaries, that is something else, isn't it?

A. I don't think it is fair to bring that up, because I have told you that that question did not exist. If you want to——

Q. No, I just want an answer, yes or no. I am not disputing anything.

A. That is a hypothetical question. I would rather leave that to you as an attorney to give an opinion if you want to.

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[293] Id., Commission's Exhibits Nos. 839, 840, 843, 844, 1183.

[294] Id., at 8671.

[295] Id., at 8695–7.

Q. If this transaction was effected, or worked out, this Class "A" stock would be washed out?

A. That is right. It was, right after that.

Q. So that if this went through, you would never have to face the question that Mr. Schenker poses, namely, the legality of the vote of the Class "A" stock on a consolidation?

A. Right. The question did not come up. We were interested in this transaction. This transaction eliminated the stock. In retrospect I can see your point of view, but I don't think the question came up.

At a meeting of the stockholders of United Founders Corporation, held on October 10, 1935,[296] the cancelation of the Class A stock and the issuance of the 6,000,000 shares of common stock to The Equity Corporation were approved by 7,230,669 of the total of 13,500,234 votes outstanding. Included in the 7,230,669 approving votes were 5,727,907 cast by The Equity Corporation, of which 4,500,000 votes represented the vote of the Class A stock.[297] In other words, of the 7,772,327 votes to which stockholders other than The Equity Corporation were entitled, only 1,502,762 were cast in favor of the transaction.[298] In essence, The Equity Corporation had itself approved its own transaction with United Founders Corporation. David Milton, the president of The Equity Corporation, testified:[299]

Q. Didn't you consider that by virtue of your control of 42% of the voting power of United Founders Corporation that you had some obligation to the United Founders Corporation common stockholders?

* * * * * * *

Mr. Huntington [a director of The Equity Corporation]. As we said, it had 42% which made available the stock for the purpose, as I said, of balancing this structure.

Q. First it made available the stock for the purpose of voting an exchange in which The Equity Corporation was interested, when The Equity Corporation was dealing with a company of which The Equity Corporation controlled 42 percent of its stock.

Mr. Milton. That is right.

Q. And you had no feeling of uneasiness on the part of The Equity Corporation in casting these 5,700,000 votes in order to get the honest and necessary reaction of the stockholders on this deal?

A. No, we considered it a very constructive transaction.

Q. The purpose of the vote was not to determine whether it was constructive or not; you wanted to get the reaction of the stockholders to this deal.

A. We wanted to disclose it fully to the stockholders and give them a chance to express themselves on the transaction.

Q. The Equity Corporation did cast five million votes in favor of the transaction?

A. There is no question about it. We have had that evidence.

Q. Out of 5,700,000 votes, 4,500,000 votes on that Class "A" stock which was absolutely valueless, isn't that so?

A. I will not say that it was valueless at all.

Q. It had no asset value.

[296] Id., at 8651.
[297] Id., Commission's Exhibit No. 1197.
[298] Id., at 8656 and Commission's Exhibit No. 1197.
[299] Id., at 8653–5.

A. It had an asset value. It had a small amount of asset value, but it had a value. And, regardless of that, it had a third vote and that vote was cast.

Q. If you take away that vote, Mr. Milton, that was cast on this Class "A" stock and the 1,200,000 votes which were cast by The Equity Corporation on its common, that meant that there was approximately 1,500,000 votes cast in favor of the proposition, which is 16 percent of the total outstanding nine million shares?

A. I think your answer is correct.

Other more formidable obstacles stood in the way of the consummation of The Equity Corporation's plan for the consolidation of United Founders Corporation and its subsidiaries. The charters of each of the United Founders Corporation companies having preferred stocks outstanding, with the exception of International Securities Corporation of America, contained provisions prohibiting any consolidation of the corporation with other corporations which would in any way "impair the rights and preferences" of the preferred stock.[300] The Equity Corporation's contemplated plan of consolidation proposed, in several of its aspects, to alter sharply the rights and preferences of the preferred stockholders of the various United Founders Corporation companies. On their face, therefore, these clauses would seem to frustrate the plans of The Equity Corporation. However, it might be argued that these charter provisions were invalid as inconsistent with the laws of Maryland (under which all of the United Founders Corporation group of companies were created) which permit corporations, in general terms, to consolidate.[301] On the other hand, these charter provisions did not prevent a consolidation; they merely interdicted a consolidation which did not preserve the rights and preferences of the preferred stocks.[302] In any event, as will be seen, The Equity Corporation took steps to eliminate these

[300] For example, the charter of Second International Securities Corporation provided that: "A consolidation or merger of the corporation with any other corporation or corporations shall not be deemed to be a liquidation, dissolution, winding-up, or distribution of capital within the meaning of this clause, but any such consolidation or merger shall in no way impair the rights and preferences of the first preferred stock" (id., Commission's Exhibits Nos. 881 (p. 10) and No. X3406–B (p. 10)). For the similar provisions in the charter of American Founders Corporation, see id., Commission's Exhibits Nos. 859 (p. 3) and 3404–B (p. 11)).

[301] Md. Code Ann. (Bagby 1924, Art. 23, § 33. Although the Maryland laws permit the inclusion in corporate charters of any provisions defining, limiting, or regulating the power of the stockholders and of the corporation, it is also provided that such provisions must not be contrary to the laws of the state nor "inconsistent with any of the terms and limitations" of its corporation law (Md. Code Ann. (Bagby 1924), Art. 23, § 4 (g)).

[302] Although one court has taken the attitude that these clauses are invalid as inconsistent with statutes permitting the consolidation of corporations, conceivably the Maryland courts might give effect to these clauses in the charters of the various United Founders Corporation companies. In *Jones* v. *St. Louis Structural Steel Co.*, 267 Ill. App. 576 (1932), the Illinois Appellate Court (an intermediate court of appeal) held that a provision in the charter of a Delaware corporation prohibiting a merger which would impair the rights of the company's preferred stock was invalid because it conflicted with the Delaware corporation law (Del. Rev. Code (1915), C. 65, § 59), which, in general terms, authorized the merger and consolidation of corporations. The court based its conclusion that the Delaware law contemplated and authorized mergers which would impair the rights and preferences of preferred stockholders, in large part upon the fact that the Delaware legislature had provided a means by which stockholders dissatisfied with the terms of a merger might obtain an appraised value in cash of their securities in lieu of accepting the securities allotted to them under the merger plan. The Maryland law also grants to dissenting stockholders a right to receive an appraised cash value of their securities in lieu of acceptance of the terms of a plan of merger or consolidation.

clauses from the charters of the various companies prior to their consolidation.

Still another problem confronted The Equity Corporation. Unlike the Delaware law which requires, for the approval of a merger or consolidation, only the assenting vote of stockholders of two-thirds of a corporation's outstanding securities irrespective of class,[303] the Maryland law, as a condition to the consummation of a consolidation, requires the approval of holders of two-thirds of the securities of each class having voting power, voting by classes.[304] Six of the seven United Founders Corporation companies were incorporated in Maryland, and five of these companies had outstanding preferred stocks which were entitled to vote.[305] And, as has been pointed out, although The Equity Corporation through its holdings of the stock of United Founders Corporation controlled two-thirds of all of the voting securities of each of the United Founders Corporation companies, it did not, in nearly all cases, control two-thirds of each class of their preferred stocks. Thus, The Equity Corporation controlled directly or indirectly only 51.3% of the 7% preferred stock and 51.1% of the 6% preferred stock of American Founders Corporation; 0.7% of the preferred stock of American & General Securities Corporation; 27.2% of the 6% preferred and 32.3% of the 6½% preferred stocks of International Securities Corporation of America; 4.5% of the first preferred stock of Second International Securities Corporation; and 38.7% of the preferred stock of United States & British International Co., Ltd.[306]

To secure approval of its plan, The Equity Corporation would thus have to obtain the consent of a large number of the public holders of the preferred stock of the various subsidiaries of United Founders Corporation. In view of the various features of The Equity Corporation's plan of consolidation which might be disadvantageous to such preferred stockholders, their consent obviously might be difficult to obtain. Further, a solicitation campaign to procure consents to the plan would be expensive. Obviously The Equity Corporation would desire to avoid any necessity for procuring the approval of its plan by the public holders of the preferred stocks of the various companies in the United Founders Corporation group.

The Equity Corporation then proceeded under the Maryland corporation laws in such manner as to obviate the necessity for a class vote of the holders of two-thirds of the preferred stocks as a condition precedent to the consummation of the consolidation plan. A

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[303] Del. Rev. Code (1915), ch. 65, 59. American and Continental Corporation was the only member of the United Founders Corporation group of companies which was incorporated in Delaware. Since The Equity Corporation controlled indirectly two-thirds of the outstanding securities of American and Continental Corporation, the obstacle of a class vote which confronted The Equity Corporation in the case of the other United Founders Corporation companies was not present. American General Corporation, the unconsolidated company, was also incorporated in Delaware (op. cit. supra, note 240, Commission's Exhibit No. 862). Both the Delaware (Del. Rev. Code, ch. 65, § 59) and Maryland laws (Md. Code Ann. (Flack Supp. 1935), Art. 23, § 33½) permit the consolidation of domestic with foreign corporations, if the laws of the state of incorporation of the foreign corporation contain a reciprocal authorization.

[304] Md. Code Ann. (Flack Supp. 1935), Art. 23, § 33 (3).

[305] American Founders Corporation, American & General Securities Corporation, International Securities Corporation of America, Second International Securities Corporation, and United States & British International Co., Ltd.

[306] Op. cit. supra, note 240, Commission's Exhibit No. 843.

section of the Maryland law provides that irrespective of any statutory requirement that action be taken or authorized by vote of the holders of a designated proportion of the corporate securities, such action "shall be effective and valid if taken or authorized by such vote of its stockholders * * * as may be required for such action by its charter."[307] In other words, if the charters of the companies so provided, the consolidation could be approved by two-thirds of all the outstanding stock irrespective of class. However, the charters of the five United Founders Corporation companies having preferred stocks outstanding contained no provisions authorizing a consolidation or a merger upon a vote different from that specified in the consolidation statute. If, therefore, the charters could be amended to provide for approval of the consolidation or merger by two-thirds of all the shares outstanding (an amount of voting power which The Equity Corporation itself controlled in every case), and if such an amendment could be effected without the necessity of a class vote, The Equity Corporation could accomplish its objective. By amendments, also, the clauses in the corporate charters of the companies having outstanding preferred stocks prohibiting a consolidation impairing the rights and privileges of the preferred stocks, could be eliminated.

The charters of the various United Founders Corporation companies contained provisions authorizing amendments thereto on the vote of the holders of a majority of their voting shares irrespective of class. But in the case of two of the corporations—American Founders Corporation and International Securities Corporation of America—amendments which would change the "preferences or rights" of the holders of the preferred shares required the approval of the holders of all of the preferred and of two-thirds of the preferred shares, respectively.[308] The charters of the other companies contained provisions forbidding an amendment which changed the preferences (but not the rights) or redemption price of the preferred stock without the consent of the holders of two-thirds of such stock.[309] Moreover, the Maryland law[310] provides that no charter amendment which changes the contract rights of any outstanding stock shall be valid, in the absence of a reservation in the charter to make such amendment, unless such change in the contract rights of a stock shall have been authorized by a vote of all of the holders of such stock.

Certainly it can be argued that the statutory requirement of a class vote and the charter provisions forbidding a consolidation which would impair the rights and preferences of preferred stocks are contract rights of such stockholders. Furthermore, the amendments were apparently intended merely as a preliminary to a con-

[307] Md. Code Ann. (Flack Supp. 1935), Art. 23, § 23. The statute provides that in no case, however, except when authorized by law, could any corporate action be taken by the vote of less than the holders of a majority of the outstanding voting securities of a corporation.

[308] See the reply to the Commission's questionnaire for American Founders Corporation, Pt. I, Exhibit B, p. 24; op. cit. supra, note 240, Commission's Exhibit No. 860, p. 12 (International Securities Corporation of America).

[309] See for example the charter of Second International Securities Corporation, op. cit. supra, note 240, Commission's Exhibit No. 861, p. 22.

[310] Md. Code Ann. (Bagby 1924), Art. 23, § 28.

solidation which would actually sharply change the preferences, dividend rights, and redemption prices of the preferred stocks of the various United Founders Corporation companies. The amendments were thus intended to enable The Equity Corporation to accomplish indirectly an alteration in the preferences and dividend rights of the preferred stocks of the various companies, which it could not have accomplished directly, except with the approval of the holders of two-thirds of the preferred shares affected by its plan.

The validity of The Equity Corporation's proposed amendments would be doubtful, unless, pursuant to the charters of the various United Founders Corporation companies, the approval of the requisite percentage of the preferred stockholders was obtained. In the case of American Founders Corporation, the approval of all the preferred stockholders might have to be obtained; in the case of International Securities Corporation, The Equity Corporation's proposed amendment might be invalid unless the approval of the holders of two-thirds of the preferred stock was obtained. And if the Maryland statute, which has already been described, requiring unanimous approval by the stockholders affected, of any amendment changing the contract rights of such stockholders unless reservation of the right to make such amendment is made in the charter, is construed to require the reservation of the right to make the specific amendments contemplated by The Equity Corporation, the passage of such amendments without the unanimous approval of the preferred stockholders might be void. None of the charters of the companies which did not carry provisions interdicting amendments which changed or altered preferred stockholders' "rights" unless the approval of a specified percentage of such stockholders was obtained, contained clauses reserving the right to make the specific amendments proposed by The Equity Corporation by a percentage of preferred stockholders less than that required by the Maryland statute.

Notwithstanding the dubious legality of its proposed amendments in the event that the approval by the percentage of the preferred stockholders required either by the Maryland law or by the charters of the various companies was not obtained, The Equity Corporation, at a meeting of the stockholders of the several companies held on November 4, 1935 called to approve both the amendments and the consolidation plan, proceeded to approve its proposed amendments by the vote of virtually only the shares under its control.[311] In each case The Equity Corporation cast the vote of two-thirds of the total voting securities in favor of its amendments. But in no case were the amendments approved by the holders of all or even two-thirds of the preferred stocks.[312] One hour later the consolidation which, as a result of the amendments, could be ostensibly sanctioned by the vote of only the holders of two-thirds of all the voting securities outstanding rather than by a class vote of the holders of two-thirds of the securities of each class, was approved. The vote in favor of the consolidation was substantially that of the shares under the control of

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[311] Op. cit. supra, note 240, Commission's Exhibits Nos. 843, 1196.

[312] Approximately only 50% of the preferred stocks of American Founders Corporation; 12½% of the preferred stock of American & General Securities Corporation; 40% of the stock of International Securities Corporation of America; 20% of the first preferred stock of Second International Securities Corporation; and 50% of the preferred stock of United States & British International Co., Ltd., voted in favor of the amendments (ibid.).

The Equity Corporation,[313] and in each company, favorable votes were cast by far less than two-thirds of the preferred stock.[314]

However, the legality of the amendments and of the consolidation did not go wholly unchallenged. The announcement of the proposed amendments and of the consolidation was followed by several suits filed by preferred stockholders of American Founders Corporation, American & General Securities Corporation, and International Securities Corporation of America to enjoin their companies from proceeding with their announced plan.[315] The Equity Corporation, however, quickly settled these suits on advantageous terms to the litigants.[316] Other preferred stockholders, however, had no recourse but to accept the terms of the plan of consolidation or to assert their appraisal rights if they were aware of them.

Obviously The Equity Corporation's dominant position in the various United Founders Corporation companies enabled it to formulate and consummate a plan of reorganization of its own choosing. Its superior position and its financial ability enabled it either to vitiate or to minimize the possible impeding effect on its plan of every safeguard provided in the Maryland statutes for the protection of stockholders adversely affected by a plan of consolidation. The comparatively few minority preferred stockholders who were aware of their legal remedies or of their right of appraisal and had the financial means to pursue such rights, fared better than the bulk of such minority stockholders who, in most cases against their will, were bound into a plan which sharply reduced the dividend and liquidating preferences and the redemption rights of their shares.[317]

2. MANAGEMENT CONTROL OF SOLICITATION MACHINERY

In addition to their dominant position in the preparation of plans for the amalgamation of the assets of two or more companies and in the selection of the statutory procedure for effectuating such plans, the managements of investment companies are also in control of effective devices for securing the assent to their plans of the percentage of stockholders required by state laws.

a. Control of the Proxy Machinery

Typically the great bulk of stockholders in management investment companies own individually only a few shares of voting stock. Thus, an analysis of the distribution of the securities of 14 large investment companies at the end of 1936 reveals that approximately one-fourth of all the common stockholders held only 10 shares or less and well

[313] Id., Commission's Exhibits Nos. 1196, 1197.

[314] Id., Commission's Exhibits Nos. 843, 1196.

[315] Id., Commission's Exhibits Nos. 829, 858.

[316] Id., Commission's Exhibit No. 858. See supra, this section, pp. 1423–4.

[317] Stockholders who sued to enjoin the consummation of the consolidation received in settlement of their suit a sum which exceeded both the market and the asset value of the securities they would have received under the plan (id., Commission's Exhibit No. 1202). Similarly, stockholders who claimed their appraisal rights received cash settlements in excess of the market and at times in excess of the asset value of the securities they would have received under the plan of consolidation (id., Commission's Exhibit No. 1202 and *American General Corporation* v. *Camp*, 190 Atl. 226 (Md. 1937)).

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over one-half of the stockholders held only 50 shares or less. Stated in terms of the market value of the holdings of the common stockholders in these companies at the end of 1936, approximately one-half of the common stockholders of all types of management investment companies held shares with a total market value of $500 or less, and the holdings of about 93% of the common stockholders had a market value of $5,000 or less.[318]

Typically, also, the vast majority of the voting stock of investment companies is widely distributed geographically, although a pronounced concentration of stockholders appears in those states in which important financial centers are located, particularly in New York, Massachusetts, Illinois, and California. The concentration in those states is further accentuated by the fact that a majority of the brokers, banks, and other nominees who are the record but not the beneficial owners of a considerable proportion of all of the common stock of investment companies, are located in these leading financial centers.[319]

On the other hand, the large blocks of voting securities of investment companies are usually concentrated in the hands of small groups of stockholders.[320] These holders of the larger blocks of voting securities usually include the management or interests affiliated with or friendly to the management.[321] In fact, the holders of the larger

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[318] Part Two (House Doc. No. 70, 76th Cong.), Ch. V, pp. 379–87.

[319] Ibid. For example, The Lehman Corporation, a large closed-end nonleverage management investment company, had, at December 31, 1935, stockholders in 32 states, but 40% of the stockholders owning 62% of the outstanding shares were located in New York, and 10% of the stockholders holding 2% of the voting stock were located in Illinois (ibid.). Atlas Corporation, a large closed-end leverage management investment company, at May 31, 1934, had outstanding 262,025 preference shares owned by 5,474 stockholders situated in every one of the States and territories of the United States and in several foreign countries. However, 2,072 stockholders owning 143,770 shares were located in New York. Of the 4,266,050 common shares of Atlas Corporation then outstanding, 2,840,876 shares were owned by 19,876 stockholders residing in New York (Public Examination, Atlas Corporation, Commission's Exhibit No. 2002, pp. 18–23).

[320] An analysis of the stock distributions as at December 31, 1936, of the voting securities of 14 large management investment companies of all types indicates that only ⅕ of 1% of the number of stockholders owned 20% of all of the outstanding shares, and less than 5% of the stockholders owned well over one-half of the outstanding stock. (Part Two [House Doc. No. 70, 76th Cong.], Ch. V, pp. 362–6 and 388–92.)

[321] Part Two (House Doc. No. 70, 76th Cong.), Ch. V, pp. 419–31.

[322] An instance of this character occurred in connection with the merger in December 1932 of Chicago Investors' Corporation with Continental Chicago Corporation (now known as The Chicago Corporation). Chicago Investors' Corporation was organized in 1927 by a group of Chicago financiers (Public Examination, The Chicago Corporation, at 9658–9). Field, Glore & Co. (now known as Glore, Forgan & Company), Chicago and New York investment bankers and brokers, also became associated with the company (id., at 9661). As at November 15, 1932, Chicago Investors' Corporation had outstanding 135,000 shares of preference stock and 450,000 shares of common stock (id., Commission's Exhibit No. 928). In July 1931 Atlas Corporation began to purchase the securities of Chicago Investors' Corporation from insiders (a block of 100,000 common shares was purchased from Field, Glore & Co. at a price of $4 a share as compared with the market price of $2 for such shares [id., at 9790]), and on the market. By the summer of 1932 Atlas Corporation had accumulated 32,700 shares of the preference stock and 150,000 shares of the common stock of Chicago Investors' Corporation (id., at 9790 and 9799, and derived from supplementary information supplied the Commission for Chicago Investors' Corporation). These holdings constituted approximately 30% of the outstanding voting securities of Chicago Investors' Corporation. The directors of Chicago Investors' Corporation refused, however, to accede to Atlas Corporation's request that they recommend exchange offers of Atlas Corporation's securities for the remaining outstanding securities of Chicago Investors' Corporation (id., at 9794–5). Instead, in order to eliminate any possibility of Atlas

blocks of voting stock are likely to have been most influential in the election of the management, and their approval of a management's proposed plan of merger or consolidation probably would be obtained prior to its promulgation. Moreover, as the price of their agreement to the plan of the management, influential shareholders may be granted preferences not accorded to other stockholders.[322]

Infrequently, however, does the management and its friendly large stockholders control the percentage of voting securities—usually two-thirds—required by state laws to consummate a plan of merger or consolidation.[323] Usually, therefore, the managements will have to obtain the assent of a large number of the public investors in the

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Corporation's acquisition of actual control of Chicago Investors' Corporation, the directors determined to merge it on a share for share basis with Continental Chicago Corporation, a company with which Field, Glore & Co. was affiliated and the capital structure of which was similar to that of Chicago Investors' Corporation (id., at 9793, et seq.). Atlas Corporation, however, apparently would not agree to the merger, unless its preference shares of Chicago Investors' Corporation were purchased by that company. In December 1932, immediately prior to the merger of Chicago Investors' Corporation and Continental Chicago Corporation, Chicago Investors' Corporation purchased from Atlas Corporation 32,700 shares of its preference stock from Atlas Corporation at a price of $23 a share (id., at 9799). The record does not indicate that this purchase was revealed to other preference stockholders or that a similar cash offer for their shares was made to them. At the date of the purchase the market price of Chicago Investors' Corporation preference stock was $17 a share. Other preference stockholders (with the exception of those who elected to have their shares appraised) received on the merger preference stock of Continental Chicago Corporation which also had a market value of $17 a share. Charles F. Glore, a director of Chicago Investors' Corporation, conceded that the purchase of Atlas Corporation's preference stock was made to eliminate its possible opposition to the merger (id., at 9799):

> Q. Do you recall that the purchase of that stock was a condition under which Atlas agreed to approve of the consolidation?
> A. No; I don't recall that it was. It may have been.
> Q. Let me read the preamble from the minutes of the meeting of the board of directors held some time in September of 1932:
>
> > "Whereas Atlas Corporation has refused to approve such a consolidation but has indicated it would approve the consolidation if in connection therewith it could sell its preference stock of Chicago Investors' Corporation at $30 a share * * *."
>
> Subsequently you bought it all at a price of $23.
> A. Then it was a condition.

Compare also the special treatment accorded to the managements of various investment companies on the transfer of their control to others, described in this chapter, supra, pp. 1078–1356.

[323] Compare the following percentage of voting securities held by the managements and interests affiliated with the managements of the following investment companies during 1935: [a]

Name of company	Percent of voting securities controlled by management and interests affiliated with management
The Lehman Corporation	8.7
Tri-Continental Corporation	7.0
The Chicago Corporation	3.5
The Adams Express Co	3.9
Quarterly Income Shares, Inc	0.6
United States & Foreign Securities Corporation	45.8
General American Investors Co., Inc	43.5
Consolidated Investment Trust	1.0
National Bond & Share Corporation	20.8
Prudential Investors, Inc	2.3
Atlas Corporation	4.8
The Equity Corporation	20.0

[a] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. V, pp. 419–31.

securities of the companies which are parties to a plan of merger or consolidation. Normally, however, the geographical diffusion of the public stockholders, coupled with the smallness of their individual financial stake in the corporation's assets, makes it unlikely that large numbers of such shareholders will appear in person at the place of the shareholders' meeting.[324]

As a consequence, the vast majority of stockholders, if they vote at all on plans of merger or consolidation, vote by proxy, that is, by designated agents who appear at meetings in person to vote in behalf of the stockholders. Written agreements designating the management's nominees as proxies and authorizing such nominees to vote in favor of plans of merger or consolidation are sought from stockholders by the management of their corporations. And the management is in an effective position to obtain these proxies even in the presence of organized opposition by stockholders to the management's plans.[325] First, the management has the use of the list of the corporation's stockholders; it thus knows the names and addresses of all stockholders. Second, the management has the advantage of the use of the corporate funds to finance its solicitation of proxies. Third, the management's prestige and reputation, coupled with the normal inertia and resistance of stockholders to new influences, is of great benefit to the management in its solicitation campaign. Fourth, the management will have the active cooperation of brokers, commercial banks, and investment bankers who are either doing business with the company or hope for future business advantages as the price of their

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[324] More than a majority of the existing investment companies were incorporated in Delaware and Maryland where their stockholders' meetings are usually held. However, few stockholders of investment companies reside in these states, and to appear in person at meetings requires an expenditure for traveling expenses which the average small stockholder is unwilling to incur. To illustrate: As at March 31, 1934, there were outstanding 262,025 shares of Atlas Corporation's preference stock held by 5,474 shareholders, only 9 of whom, holding 306 shares, resided in Delaware, the place of the stockholders' meeting. Similarly, of the 4,266,050 shares of the common stock of Atlas Corporation held by 38,875 shareholders, only 7,437 shares were held by 84 residents of Delaware (Public Examination, Atlas Corporation, Commission's Exhibit No. 2002, p. 18 et seq.). At the meeting of stockholders held on October 31, 1936, to vote on a plan to consolidate Atlas Corporation, Pacific Eastern Corporation, Shenandoah Corporation, and Sterling Securities Corporation, only one stockholder, other than representatives of the management, of any of these companies appeared in person (Part Two [House Doc. No. 70, 76th Cong.], Ch. V, pp. 398–402). Rarely do stockholders appear in person at the stockholders' meetings of the larger investment companies (ibid.).

William J. Thorold, the president of Federated Capital Corporation, an investment company the shares of which were held by 6,000 stockholders, could not recall a stockholders' meeting which was attended by more than 23 persons. Mr. Thorold testified (Public Examination, Federated Capital Corporation, at 14536–7):

> Q. Were there more than 10 stockholders at any meeting?
> A. I should think so, but a great many of those that were there represented proxies of other people.
> Q. You mean there were a great many that you got from brokers where they held the security in street names?
> A. No, no.
> Q. First give me the actual number of people who were there, then you can tell me in what capacity they were there and whom they represented. I am just trying to see the attendance.
> A. All right. Here is one at which there were 23.
> Q. What was the peak amount of stockholders that were in Federated Capital?
> A. * * * I should say 6,000.
> Q. And this special meeting you talked about had 23?
> A. Yes.

[325] The effectiveness of the proxy machinery as a device to perpetuate management control is described and discussed in Part Two (House Doc. No. 70, 76th Cong.), Ch. V, p. 402.

cooperation.[326] In many cases brokers, commercial banks, and investment banks may hold record title to the securities of the investment company either as pledgees or nominees of the stockholders with power to appoint proxies.[327] The management is also in a position to pay brokers, banks, and securities dealers for their recommendation

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[326] For example, The Equity Corporation, in connection with the exchange of its holdings of the Class A stock of United Founders Corporation and other securities for 6,000,000 shares of the common stock of United Founders Corporation, which has already been described (see supra, pp. 1491–5), procured assents of United Founders Corporation's common stockholders to the exchange by procuring proxies from friendly brokers who held such shares as nominees of the actual owners of the common stock of United Founders Corporation. (Public Examination, The Equity Corporation, at 8657–8).

[327] It is the common practice of brokers to record in their own names on the books of the issuing corporations, securities pledged with them in margin accounts or otherwise held for the account of customers who hold actual title to the securities. (See 41 A. L. R. 1258, et seq.) In fact, the record ownership of substantial blocks of corporate securities may be held in "street names," that is, in the names of brokers or other securities dealers (Report of the Senate Committee on Banking and Currency on Stock Exchange Practices, 73d Cong., Senate Report No. 1455 (1934), p. 74, et seq.; N. Y. Stock Echange Bulletin, Vol. X, No. 1, January 1939).

Ordinarily a corporation need not inquire beyond its records to determine who are its stockholders entitled to vote at and to receive notice of its corporate meetings (5 Fletcher, *Cyclopedia Corporations* (1931), § 2033). However, pledgors, in the absence of a contrary agreement with the pledgees, are entitled to vote the pledged securities (id., § 2034 and Del. Rev. Code (1935), c. 65, § 18) and a court of equity will compel the pledgee to issue a proxy to the pledgor (5 Fletcher, *Cyclopedia Corporations* (1931), § 2059; *In re Argus Printing Co.,* 12 N. D. 434, 48 N. W. 347 (1891). Similarly, a court of equity will compel a mere nominee record holder of a security to issue a proxy to the actual owner of such securities. (See *Thompson* v. *Blaisdell,* 93 N. J. L. 31, 107 Atl. 405 (1919).)

Nevertheless, in the absence of a request for a proxy by the actual owners of the stock, the record owners usually will issue proxies to vote the shares registered in their names. Until recently the rules of the New York Stock Exchange provided that a member or a member firm which was the record owner of securities, in the absence of a demand for a proxy by the actual owner of such securities, could give a proxy to vote such securities if the member firm or member had an interest in such securities, or if the securities were in the possession of the member firm or member or if they belonged to a customer of the firm (rules of the Governing Committee of the New York Stock Exchange, Ch. XIV § 10, adopted July 7, 1927). Under this rule proxies were freely given to corporate managements by member firms of the New York Stock Exchange who held record title to shares actually owned by their customers. (See Report of the Senate Committee on Banking and Currency on Stock Exchange Practices, 73rd Cong., Senate Report No. 1455 (1934), p. 74, et seq.) However, it may be doubted that this rule of the stock exchange would absolve a brokerage firm from a liability for damages to a customer where, without the customer's knowledge or consent, the brokerage firm gives a proxy to a corporate management with knowledge that the action to be taken at the corporate meeting is the approval of a plan of merger or consolidation. (See *Leonard* v. *Woodruff,* 259 Mich. 434, 243 N. W. 252 (1932).) In fact, the courts have held that a general authority given by a stockholder to another to vote his shares at corporate meetings would not include the power to vote the shares with reference to a plan of merger, consolidation, sale of all of the corporate assets, or other corporate reorganization (*Smith* v. *Smith,* 3 Desaus 557 (S. C. 1813); *Shield* v. *Lone Star Life Ins. Co.,* 202 S. W. 211 (Tex. Civ. App. 1918); *Farish* v. *Cienegunta Copper Co.,* 12 Ariz. 235, 100 Pac. 781 (1909)).

The Commission, by Sec. 14 (b) of the Securities and Exchange Act of 1934, is empowered to make rules and regulations with reference to the granting of proxies by members of securities exchanges or other securities dealers who transact business through the medium of such members. No rules have as yet been promulgated by the Commission pursuant to this section. However, the New York Stock Exchange has amended its rules recently. The present rules of the New York Stock Exchange, in effect since January 16, 1939, prohibit the giving of proxies by member firms who hold record title to securities owned beneficially by customers where the member firm has knowledge that the purpose of the corporate meeting is to authorize a "merger, consolidation, or any other matter which may affect substantially the legal rights or privileges of such stock," unless the broker holds record title to the securities in a representative or fiduciary capacity with authority

of the management's plan to the stockholders and for obtaining proxies from such stockholders.[328] The effectiveness of the proxy machinery as an aid to the objectives of the management of an investment company was described by Thomas E. Brittingham, a member of a protective committee of the stockholders of Fourth National Investors Corporation, which, as has already been related, in 1934 successfully resisted a management plan to consolidate Fourth National Investors Corporation with National Investors Corporation and other affiliated corporations:[329]

A. If you have ever had any experience in a proxy fight in an investment trust, it is rather enlightening. In the first place, the management in power distributes their brokerage rather effectively, so that when it comes to a stockholders' fight, brokers that have had favors in the past are expected and do get out and solicit proxies. That puts the stockholders' committee at quite a disadvantage because it gives the brokers with offices all over the country personal contact that is rather hard to beat.

Q. Do you think that that situation was enhanced by the fact that National [National Investors Corporation, which was in effective control of Fourth National Investors Corporation] itself had originally been privately created through banks in order that they might assist in the distribution of the subsequent trusts?

A. That had a tremendous amount to do with it, particularly in Detroit. The bankers there, with the exception of Detroit Trust Company, used their influence to get their customers and trust accounts that were left with them to favor the management and while it is true that several of those banks, I guess most of them, have been reorganized, still through personal contact and other means the interest is there, so it is sort of a repercussion of having given a lot of warrants out to the bankers. It was hard in talking with the stockholders—they would say: "Well, I am going down to see my friend Banker So-and-so." The banker having an interest in National Investors naturally told him where to give his proxy.

Q. You really ran across those cases?

A. Quite a few of them; yes.

Q. You were not able to overcome the advice the banker gave?

A. No, sir. I spent several days in Detroit in two different years and the results are practically negligible.

Q. You could not overcome the advice of the bankers?

A. No, sir.

Obviously these management advantages in the solicitation of proxies place stockholders who desire to form protective committees to combat management proposed plans of merger, consolidations, or other voluntary corporate readjustments under severe handicaps.

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to vote such securities, or has been instructed by the beneficial owner to issue the proxy. (See Rules 770 to 775 of the Board of Governors of the New York Stock Exchange.)

However, as has been elsewhere stated, the great majority of existing investment companies do not have their securities listed on the New York Stock Exchange or other exchanges. Their securities are traded over the counter, and over-the-counter dealers, unless they are members of the New York Stock Exchange, are not bound by its rules.

[328] Compare the solicitation methods used by Atlas Corporation and The Equity Corporation in connection with their exchange offers, described in this chapter, pp. 1357–1410, and in the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committtees (1938), Part VII, p. 232, et seq.

[329] Public Examination, National Investors Corporation, at 4480–1.

Such stockholders will be unable to contact other stockholders unless they possess an accurate and complete list of their names and addresses. But such lists are controlled by the management, and, although both the courts and state statutes permit stockholders to inspect and copy the stockholders' list in the possession of the corporation or its registrar and transfer agents for a legitimate purpose, such as the formation of an organization of stockholders,[330] the management can severely hamper stockholders in their attempt to obtain stockholders' lists. The management may refuse to give its list to applying stockholders.[331] If such stockholders are compelled to institute a suit in order to obtain the list, by the time that the legal proceedings are terminated the management may have attained its objective. Even if the management permits inspection of the stockholders' list, it may not cooperate in the preparation of copies of the list and may create many mechanical difficulties. James E. Brittingham, who headed a protective committee for stockholders of Fourth National Investors Corporation formed in 1934, testified:[332]

Q. You had a stockholders' list?

A. Much to the chagrin of the Fourth National Investors management we obtained a stockholders' list without their cooperation.

Q. How did you get it?

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[330] See 5 Fletcher, *Cyclopedia Corporations* (1931), §§ 2214, 2239; *Grayburg Oil Co.* v. *Jarratt*, 16 S. W. (2d) 319 (Tex. Civ. App. 1929); *Withington* v. *Bradley*, 111 Me. 384, 89 Atl. 201 (1914).

[331] For example, Leopold M. Stern and Gilbert R. Fales, stockholders of Interstate Equities Corporation who attempted to organize a protective committee to resist the exchange offers of The Equity Corporation for the shares of Interstate Equities Corporation, which was controlled by The Equity Corporation, met with a refusal on the part of The Equity Corporation to furnish them with an up-to-date list of the stockholders of Interstate Equities Corporation even though they offered to bear the expense of the compilation of such a list (Public Examination, The Equity Corporation, Commission's Exhibit No. 1051). R. Sherrard Elliot, the secretary of The Equity Corporation, testified (id., at 10821–2):

Q. Now you don't deny, Mr. Elliot, that if Messrs. Stern and Fales had a list of stockholders, their efforts would have been more effective than having to try to find out who the stockholders were? Do you deny that?

A. No; I don't deny it.

Q. And you don't deny that you were conscious of the difficulty they were experiencing in contacting the stockholders of the Interstate Equities Corporation?

A. No; I don't deny it.

Q. And you don't deny that every effort was being made by the management of The Equity Corporation to prevent them from getting the stockholders' list, do you?

A. Well, I think as I recall it, both the Interstate Equities Corporation and The Equity Corporation deemed that they should not have those lists.

Q. And if The Equity Corporation wanted to see them get the lists, they could have done it in five minutes? Isn't that so? They could have told the Interstate Equities Corporation to make the list available; could they not?

A. I don't deny that that would have had some weight with them.

[332] Op. cit. supra, note 329, at 4469. In the case of companies whose securities are listed on national securities exchanges, the Commission's Rules and Regulations, promulgated pursuant to Sec. 14 of the Securities Exchange Act of 1934, in large degree obviate the necessity for the procuring of security holders' lists by security holders who desire to solicit proxies in opposition to the corporate management. Rule X–14A–6 of the Commission's General Rules and Regulations under the Securities Exchange Act of 1934 provides that managements must, on the written request of any security holder accompanied by a tender of the mailing expenses, mail to those stockholders who have or will be solicited by the management for proxies, the proxy forms and other communications prepared by the applying stockholders. However, this rule applies only to companies whose securities are listed on exchanges. As has been previously stated, the great majority of existing investment companies of all types do not have their securities listed on exchanges.

A. We got it either from their records or the records of the Registrar, but it would have been very simple for them to have given us a list, but instead they made us copy off the list by hand.

Q. They didn't refuse you a list, but they simply said they would give you none?

A. They gave us no cooperation.

Even if the difficulties confronting the efforts of an independent committee to obtain the stockholders' list are overcome, such committees normally will be unable successfully to engage in a protracted struggle with the management. The committee must expend its own funds for advertising and the solicitation of stockholders' proxies. The management, on the other hand, as has been pointed out, has the use of the corporate funds to pay for the cooperation of brokers, bankers, and other securities dealers in its effort to obtain proxies.[333] As a consequence, countercircularization by the management of stockholders solicited by independent committees is likely to be successful.[334]

In the light of these difficulties encountered by attempts of independent committees to combat plans of merger or consolidation prepared by the corporate managements, it is unlikely that such plans will be seriously opposed. In the absence of effective opposition, the management's control of the proxy machinery will usually enable it to obtain the required percentage of stockholders' assents to its plan, even if such plan is unfair to shareholders. The literature used by the management in soliciting proxies, even if it, on a careful reading, will disclose unfairness in the plan, may be unintelligible to the average investor. The investor will thus tend to rely on his management or on the advice of brokers or bankers who, without the knowledge of the stockholder, may be friendly to the management or even hired to recommend acceptance of the management's plan.

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[333] Thus, Mr. Brittingham, the head of the protective committee for Fourth National Investors Corporation formed in 1934, testified (op. cit. supra, note 329, at 4470 and 4481):

> A. * * * In the meantime, the stockholders' money, Fourth National was being extravagantly expended to defeat our own interests and expended for what we felt was decidedly the interest of National Investors.
> Q. In what way?
> A. Well, they were seeking to continue themselves in office.
> * * * * * * *
> Q. Did you spend a lot of money in the fight?
> A. My first fight altogether cost us about $5,000, and our second one cost us around $3,500 or $3,600—something like that.
> Q. Where did that money come from?
> A. It was paid out of our own pocket.

In *Hall* v. *Trans-Lux Daylight Picture Screen Corporation*, 20 Del. Ch. 78, 171 Atl. 226 (1934), the court held that, while the corporate funds could not be expended to solicit proxies solely for the purpose of perpetuating the management's control, such funds could be used in the absence of proof of bad faith upon the part of the management, to solicit proxies with reference to a merger, even though the management's view of the propriety of the merger was sharply contested by other stockholders.

[334] For example, it will be recalled that the protective committee for the preferred stockholders of Atlantic and Pacific International Corporation, formed by a group of Philadelphia bankers to resist an exchange offer for such preferred stock made by The Morris Plan Corporation with the support of the management of Atlantic and Pacific International Corporation, met with little success. The Morris Plan Corporation succeeded in acquiring by its offer approximately 70% of the preferred stock of Atlantic and Pacific International Corporation. (See supra, pp. 1123–8.)

b. Management Preparation of Solicitation Literature

The solicitation literature which accompanies a management request for the stockholder's proxy contains the only information which he usually will obtain as to the terms and conditions of the management's plans for a merger or consolidation. Such literature will only reveal to the stockholders such facts which the management, in its own discretion, determines are of importance. Designing managements may conceal from the stockholders facts which may be detrimental to their personal interest, or the facts may be artfully revealed in a manner confusing and unintelligible to the average investor.[335] The advantages which will accrue to the stockholders if the plan is consummated will be emphasized. The features of the plan which are detrimental to the shareholders will be minimized or omitted, and the management usually will in its solicitation material conform only to the minimum requirements of existing corporate practices. In the past the corporate practice has not been to place before the stockholders a full statement of the terms and conditions of the plan or of his legal rights in the event of his dissension from the plan.

(1) NONDISCLOSURE OF APPRAISAL RIGHTS

The state laws, as has been stated, do not require the management to inform the shareholder of his appraisal rights. And the general practice has been to omit to disclose such rights in the solicitation literature.[336]

David M. Milton, the president of The Equity Corporation, testified that the failure of his corporation to inform the stockholders of

[335] See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), Part VII, pp. 148–87, for instances of the use of misleading financial data in the solicitation by corporate managements of proxies with reference to recapitalization plans having for their purpose the elimination of existing arrearages in dividends on preferred stocks.

[336] Thus, in the consolidation of United Founders Corporation and its subsidiaries to form American General Corporation, The Equity Corporation, which, it will be recalled, controlled the various United Founders Corporation companies, omitted in its solicitation literature to inform the stockholders of the consolidating companies of their appraisal rights. The record does not indicate that stockholders of Financial and Industrial Securities Corporation, a Maryland corporation, were informed of their appraisal rights under the Maryland laws when their company's assets were sold to The Goldman Sachs Trading Corporation in February 1929. (See infra, this section, pp. 1523–61.) Similarly, stockholders of Tri-Continental Corporation and Tri-Continental Allied Co., Inc., both Maryland companies, were not informed of their appraisal rights on the merger of these companies on December 31, 1929 (Public Examination, Tri-Continental Corporation, Commission's Exhibit No. 2081). Nor did the solicitation material used to procure stockholders' assents to the merger of The Chicago Corporation with Continental Chicago Corporation, in November 1930, and to the merger of Chicago Investors' Corporation with Continental Chicago Corporation (the present The Chicago Corporation), in December 1932, reveal to such stockholders their appraisal rights. By Section 14 of the Securities Exchange Act of 1934 the Commission is empowered to make rules and regulations with reference to the solicitation of proxies by the use of the mails or instrumentalities of interstate commerce, in respect to any security registered on a national securities exchange. Rule X–14 A–2 (Schedule 14A, item 2) of the Commission's General Rules and Regulations under the Securities Exchange Act of 1934 promulgated by the Commission, requires the solicitation material to summarize briefly or quote any applicable provisions of statutory law relating to rights of appraisal or similar rights of dissenters with respect to any matter to be acted upon pursuant to the proxy. This rule, however, applies only to companies whose securities are listed on national securities exchanges. A large number of existing investment companies have no securities listed on such exchanges.

the various United Founders Corporation companies under its control of their appraisal rights on the consolidation of such companies to form American General Corporation [337] was in accordance with usual corporate practice: [338]

Q. On the merger, did you inform the stockholders that if they were not satisfied with the terms of the merger they had the right to file notice and get an appraisal of their stock?

A. Of course, as you know, that was never put into practice. * * * It is the first time I have heard of it.

Q. Since this investigation has been going on, we have found that at least one corporation, the Atlas Corporation, has apprised their stockholders of the fact that if they didn't like the merger they would have the right to get an appraisal.

A. Yes.

Q. And previous to that, that was never the practice?

A. No.

James J. Irwin, counsel for The Equity Corporation, testified that any stockholder could ascertain his appraisal rights merely by consulting the banker or dealer from whom he had purchased his securities, and characterized stockholders who failed to ascertain their appraisal rights as "negligent." [339]

In reality, however, it is doubtful that many stockholders ever became aware of their appraisal rights.[340] Futhermore, the bankers and dealers from whom the stockholder of an investment company purchased his shares are likely to be friendly to the management, in fact may even constitute the management.

The nondisclosure to the stockholders of their appraisal rights is obviously prejudicial to their interests. It deprives them of knowledge which might be determinative in forming their decisions to reject or accept the management's plan. And in many cases the right of appraisal may be more advantageous than acceptance of the securities allocated to the stockholders under the plan. As has already been pointed out,[341] the stockholders of the various United Founders Corporation companies which were consolidated in 1935 to form American General Corporation, would have obtained, on an appraisal of their shares, a sum in excess of the market value of the shares allotted to them under the plan of consolidation.[342] In other words, stockholders who exercised their appraisal rights received for

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[337] See supra, pp. 1488–9.

[338] Public Examination, The Equity Corporation, at 8352.

[339] Id., at 12244–7.

[340] Thus, O. Kelley Anderson, the president of Consolidated Investment Trust, which was formed in 1933 as a consolidation of various investment companies originally sponsored by Kidder, Peabody & Co., a Boston investment banking house, testified (Public Examination, Consolidated Investment Trust, at 20187):

A. I would like to point out that under Massachusetts law, any stockholder who objects to any consolidation has the right to file an objection and have his stock appraised and receive cash for the same.

Q. That is all predicated on the assumption that he has had the requisite amount of legal training and is conscious of the existence of those provisions.

A. We knew that many of them did not know that and we told them about it.

[341] See supra, p. 1499.

[342] Stockholders who reached an agreement with American General Corporation in most cases received sums in excess of the market value of the shares allotted to them under the plan. Stockholders who instituted judicial proceedings to determine the appraisal value of their shares were awarded sums in excess of both the market and asset value of the shares allocable to them under the plan (ibid.).

their shares a sum which, if reinvested in the stock of the consolidated corporation, would have enabled them to purchase a greater amount of the securities of such corporation than they would have received under the plan.[343] Similarly, preferred stockholders of Chicago Investors' Corporation, which was merged with Continental Chicago Corporation in 1932, if they had been informed of and had exercised their right of appraisal, would have received a sum greater than the market value of the shares accorded to them under the plan of merger.[344] The inequity of the nonrevelation of their appraisal rights to the preferred stockholders of Chicago Investors' Corporation was further accentuated by the fact that under the plan they were to forego arrearages in dividends in the amount of $3 a share, and by the fact that Atlas Corporation, one of the largest shareholders in Chicago Investors' Corporation, demanded and obtained, as the price of its concession to the merger, the repurchase of its preferred stock by the company at a price of $23 a share, a price six dollars above the prevailing market price of the shares.[345]

(2) NONDISCLOSURE OF MATERIAL FACTS

It is clearly essential that full and complete disclosure of all material facts with respect to a plan of merger or consolidation be made to stockholders. Certainly information should be presented to the stockholders which will enable them to determine the fairness in terms of market and asset values of the exchange ratio of securities provided for in the plan. However, other financial data is of importance. The portfolios of the companies being consolidated or merged may be radically different in character, and the powers of the management of the consolidated company may be far more extensive than those of the existing companies. Thus, the consolidation or merger may result in an enterprise substantially different from that of one or more of the constituent companies. An omission to reveal the portfolios of the constituent companies and the charter powers of the consolidated company may make it impossible for stockholders to detect, in an otherwise fair plan, an intention of the management to modify the policy of existing companies from investment in diversified securities to investments for the purpose of acquiring control of industrial or other corporations. Information as to the capitalization of the various companies included in the plan is essential in order to enable stockholders to determine changes in the existing "leverage" inherent in their equity securities which might be accomplished by the plan. Information as to the extent of the holdings of the managements of the securities of the companies involved in the plan and of the extent to which the proposed plan, if consummated, will benefit the various managements, is obviously indispensable. But solicitation literature prepared by the management in many cases, whether from design or for other reasons, may omit to disclose material facts essential to an intelligent determina-

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[343] The expenses of obtaining an appraisal right, however, may offset any advantage to be derived by the exercise of the right, a fact which detracts from the practical value to the stockholders of the exercise of their appraisal rights.

[344] See *Chicago Corporation* v. *Munds,* 20 Del. Ch. 142, 172 Atl. 452 (1934).

[345] See note 322, supra. Charles F. Glore, a director of Chicago Investors' Corporation, testified (Public Examination, The Chicago Corporation, at 9786):

tion by a stockholder of the merits of a plan for consolidation, merger, or the sale of the assets of his corporation.[346]

(a) Sale of Haygart Corporation's Assets to The Adams Express Company

An example of the deficiencies in the solicitation literature prepared by managements is afforded by the case of the sale of the assets of Haygart Corporation to The Adams Express Company on December 31, 1929. Haygart Corporation had been incorporated in Delaware on November 9, 1928, by the New York investment banking houses of Hayden, Stone & Co. and Hallgarten & Co. as a closed-end nonleverage investment company of the general management type.[347] The sponsors of the corporation jointly distributed its securities to the public [348] and jointly managed the corporation.[349] At December 31, 1929, the corporation had total assets of approximately $20,000,000 [350] and had outstanding 452,120 shares of capital stock.[351] Neither Hayden, Stone & Co. nor Hallgarten & Co. owned any of the stock of Haygart Corporation as at December 31, 1929, although individual partners of such firms apparently held an undisclosed amount of the corporation's stock.[352] However, the two firms held of record, as nominees for their clients and customers, approximately 265,000 shares of Haygart Corporation stock [353]—more than a majority of the corporation's outstanding shares.

Following the crash in the securities markets in October 1929, the management of Haygart Corporation apparently determined to amalgamate it with The Adams Express Company, another investment company, under a plan whereby common stock of The Adams Express Company would be exchanged for the capital stock of Haygart Corporation. Hayden, Stone & Co. was associated with The Adams

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Q. * * * Do you recall in any case whether the notices to stockholders contained a statement they could obtain appraisal?

A. I should say not.

Q. Would you say that it is desirable generally in such situations to advise them of their rights?

A. I can see no objection to it.

[346] In addition to the instances hereinafter discussed in this chapter, see the solicitation literature prepared by the management of Alleghany Corporation in connection with the attempted consolidation with it, in July 1937, of its controlled company, The Chesapeake Corporation. This literature did not reveal any information as to the management's holdings of the securities of Alleghany Corporation or as to the extent to which the plan would benefit the management interests. (See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), Part VII, p. 401 et seq.; see also p. 248 et seq. of that report, dealing with The Equity Corporation.)

[347] Public Examination, The Adams Express Company, at 6892.

[348] Id., at 6910 et seq.

[349] The board of directors of Haygart Corporation consisted of Charles Hayden and John R. Dillon of Hayden, Stone & Co., William M. Park of the law firm of Chadbourne, Stanchfield & Levy, then counsel for Hayden, Stone & Co., and Hugh Miller and George Mersbach of Hallgarten & Co. (id., at 6887–8).

[350] Id., at 6878.

[351] Derived from supplementary information supplied the Commission for The Adams Express Company, Item 17.

[352] Op. cit. supra, note 347, at 6887.

[353] Id., at 6883.

Express Company as its "closest broker and banker." [354] Moreover, Charles Hayden and Steele Mitchell of Hayden, Stone & Co. were two of the nine members of the board of managers of The Adams Express Company, and Charles Hayden was chairman of the company's board of managers.[355]

From the viewpoint of the management of Haygart Corporation, its absorption by The Adams Express Company would be advantageous. The combination of the two companies would avoid duplication of management and would effect economies of operation and administration.[356] At the same time the amalgamation of the two companies would not affect the existing financial emoluments of the management's control of Haygart Corporation. Hallgarten & Co. would benefit by association [357] with a combined company having assets far in excess of those of Haygart Corporation.[358] Hallgarten & Co. had not theretofore been connected with The Adams Express Company. However, following the sale of Haygart Corporation's assets to The Adams Express Company, Maurice Newton and Casimer I. Stralem, partners in Hallgarten & Co. became members of the board of managers of The Adams Express Company.[359] Hayden, Stone & Co. retained the brokerage business of the combined companies. Furthermore, the control of The Adams Express Company by Hayden, Stone & Co. would be strengthened by the issuance of a large block of its common stock to the Haygart Corporation stockholders who were presumably friendly to Hayden, Stone & Co.[360]

From the viewpoint of the stockholders of Haygart Corporation, however, the plan involved a radical change in their existing legal status and in the capital structure of their enterprise. As has been stated, Haygart Corporation was a nonleverage investment company. As a consequence, the asset value of its capital stock would tend to vary directly with the rise or fall in the value of its total assets. On the other hand, The Adams Express Company was a leverage company having outstanding bonds, preferred stock, and common stock.

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[354] Id., at 6928. Hayden, Stone & Co. obtained substantially all of the brokerage business of The Adams Express Company (ibid.).

[355] Id., at 6928 and Commission's Exhibit No. 664. Mr. Mitchell and Mr. Hayden also constituted two of the six members of The Adams Express Company's executive committee (ibid.).

[356] This, of course, would be of benefit also to the stockholders of Haygart Corporation.

[357] Steele Mitchell of Hayden, Stone & Co., and a member of the board of managers of The Adams Express Company, testified (op. cit. supra, note 347, at 6827):

> If there is any close affiliation [of The Adams Express Company] with a brokerage house and an investment banking house I should say Hayden, Stone & Co. are much closer than any other group with the possible exception of Hallgarten & Co. who are represented on our board.

[358] The total assets of The Adams Express Company following its absorption of Haygart Corporation were approximately $73,000,000 (id., Commission's Exhibit No. 664).

[359] Id., Commission's Exhibit No. 664.

[360] Upon the consummation of the sale of Haygart Corporation's assets to The Adams Express Company, there were distributed to Haygart stockholders 642,000 shares of the common stock of The Adams Express Company, a block of stock equivalent to approximately one-third of the 1,759,748 shares of such common stock outstanding after the consummation of the sale (id., Commission's Exhibit No. 664). The record does not indicate that Hayden, Stone & Co. was the beneficial owner, at any time, of any substantial amount of the common stock of The Adams Express Company.

Of its net assets of approximately $70,000,000,[361] after giving effect to the absorption of Haygart Corporation's assets, approximately $10,000,000 [362] was allocable to its bonded indebtedness, and approximately $8,000,000 represented the par value and liquidating preference of its outstanding preferred stock.[363] The presence of these senior securities having a fixed asset participation of $18,000,000 in the assets of the company imparted to its common stock a substantial degree of "leverage." [364] This "leverage" would induce an increase in the asset value of the common stock proportionately greater than an increase in the value of the total corporate assets.[365] Concomitantly, a decline in the asset value of the total fund would result in a proportionately greater decline in the asset value of the common stock.[366]

In addition to the radical difference in the capitalization of the two companies, there was a sharp difference in the legal status of the stockholders of the two companies. The stockholders of Haygart Corporation were not liable for the debts of the corporation beyond the amount of their capital contributions.[367] On the other hand, The Adams Express Company was not a corporation but a joint stock association, a form of legal organization which does not insulate its stockholders of any class from liability for the debts contracted by the enterprise. The stockholders of the company were unlimitedly liable for all of its debts.[368] However, the articles of association of The Adams Express Company contained a provision that at all times the holders of the common stock were to "protect, indemnify and keep harmless the holders of the preferred stock and each of them from any and all liability, damage or expense as the holders of such stock * * * on account of any indebtedness, liability or obligation contracted or incurred by the Association." [369] The effect of this provision was to place ultimate liability for the debts of the company upon the common stockholders alone. Moreover, on a default in four quarterly dividend payments on The Adams Express Company's preferred stock, the holders of such stock were entitled to elect a majority of the board of managers of the company until such defaults were eliminated.[370]

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[361] Total assets of The Adams Express Company were approximately $73,000,000 but the company had liabilities, other than its funded debt, of approximately $2,000,000 (id., Commission's Exhibit No. 664 and derived from supplementary information supplied the Commission for The Adams Express Company, Item 17).

[362] Op. cit. supra, note 347, at 6880.

[363] Derived from supplementary information supplied the Commission for The Adams Express Company, Item 17.

[364] For a definition and description of leverage, see Part One (House Doc. No. 707, 75th Cong.), p. 28.

[365] For example, if the combined net assets of The Adams Express Company and Haygart Corporation increased 100% to $140,000,000 because of a rise in the market value of its assets, the total assets allocable to its common stock would increase from $52,000,000 to $122,000,000, an increase of approximately 135%.

[366] Thus, if the net assets of The Adams Express Company declined in value from $70,000,000 to $35,000,000, a 50% decrease, the value of the assets allocable to the common stock would decline from $52,000,000 to $17,000,000, a decline of 67%.

[367] Op. cit. supra, note 347, Commission's Exhibit No. 638 (Par. 8).

[368] Id., at 6828, and Commission's Exhibit No. 663 (p. 29).

[369] Id., Commission's Exhibit No. 663 (p. 13).

[370] Id., Commission's Exhibit No. 663 (p. 12).

Clearly, the stockholders of Haygart Corporation would need to know all of these facts in order to arrive at an intelligent decision as to the merits of the management's plan of consolidation. Particularly would this be so in the light of the fact that the procedure adopted by the management to accomplish such plan was to sell the assets of Haygart Corporation to The Adams Express Company. Under the laws of Delaware, the state of incorporation of Haygart Corporation, the assent of a mere majority [371] of the stockholders could bind dissenting stockholders to the sale, and such dissenting stockholders would have no right to an appraisal of their shares. Moreover, Hayden, Stone & Co. and Hallgarten & Co. held in their own names, for the account of clients and customers, record title to more than a majority of the outstanding shares of the stock of Haygart Corporation. In the absence of a request by the actual owners for the right to vote these shares themselves, the two firms, under the then rules of the New York Stock Exchange of which they were members, were privileged to vote these shares.[372] The record indicates that these shares, the record title of which was held by the two firms, were in fact voted in favor of the sale of Haygart Corporation's assets.[373] However, the record does not indicate whether or not the two firms informed their customers, who were the beneficial owners of the stock, of the impending sale of their corporation's shares, or requested proxies to vote the shares.

Moreover, the proxy solicitation literature prepared and circulated by the management of Haygart Corporation did not reveal to the stockholders of Haygart Corporation any of the facts regarding sponsors' connections leverage factors and legal status which have already been pointed out. On December 16, 1929 a letter [374] was addressed to the stockholders of Haygart Corporation by its management, informing them of the decision of the directors to sell the assets of Haygart Corporation to The Adams Express Company on December 31, 1929, and thereafter to dissolve Haygart Corporation on January 7, 1930. Proxies were requested from the stockholders authorizing the management both to vote for the sale of the assets of the corporation and for its dissolution.[375] The letter did not, however, indicate the terms of the exchange of the securities of the two companies, beyond stating that they would be determined equitably on the basis of the financial condition of the two companies as at December 31, 1929. The letter thus requested proxies conveying to the management of Haygart Corporation "blanket authority" to approve any plan which they might deem equitable.[376] But although the letter requested this "blanket authority," it did not point out that the common stockholders of The Adams Express Company were ultimately solely liable for all of that company's debts. Nor did it indicate the "leverage" capitalization of The Adams Express Com-

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[371] Del. Rev. Code (1935), c. 65, § 65.

[372] See note 327, supra.

[373] Op. cit. supra, note 347, at 6883–4.

[374] Id., Commission's Exhibit No. 634.

[375] Id., Commission's Exhibits Nos. 635, 636.

[376] Steele Mitchell of Hayden, Stone & Co., testified (id., at 6884):

Q. So that what they [the management] asked for was a blanket authority to go ahead on some fair and equitable basis?

A. The board of directors did essentially that.

pany and the possible adverse consequences of such "leverage" upon the asset value of the company's common stock.

Of far greater importance, however, was the nondisclosure of the intention of the management of Haygart Corporation to concede to The Adams Express Company's common stock an asset value for its "leverage" which they deemed of value to the Haygart Corporation stockholders.[377] In computing the number of shares of the common stock to be issued to the stockholders of Haygart Corporation for each share of the latter's stock, the asset value of the respective stocks was used as the basis for determination.[378] However, in computing the asset value of the common shares of The Adams Express Company, there was added to the actual asset value of such stock the sum of $3,000,000 representing the purported value of the "leverage" in The Adams Express Company's capital structure.[379] The sum of $3,000,000 was equivalent to the then discount from their par values at which the senior securities of The Adams Express Company were selling in the market, and according to the sponsors of Haygart Corporation, theoretically would constitute the cost to Haygart Corporation of acquiring in the open market a senior capitalization of the same amount and character as that of The Adams Express Company.[380]

Although the board of directors of Haygart Corporation may have in good faith deemed the leverage capitalization of The Adams Express Company to be of substantial value, the fact is that the stockholders of Haygart Corporation suffered an aggregate immediate loss in actual asset value of more than $1,100,000.[381] Furthermore, leverage, although perhaps an advantage in a period of rising market prices, is a distinct detriment in a period of falling prices.[382] In view of the downward trend in securities prices which had been indicated by the collapse of the securities markets in October 1929, two months prior to the sale of the assets of Haygart Corporation, the stockholders of Haygart Corporation, if they had been informed of the

[377] Op. cit. supra, note 347, at 6879–80.

[378] Derived from supplementary information supplied the Commission for The Adams Express Company, Item 17.

[379] Ibid. The net assets of Haygart Corporation as at December 31, 1929, were valued at $20,238,302, equivalent to a per share asset value of $44.76 on the 452,120 shares of the corporation's stock then outstanding. The actual asset value of the 1,117,737.75 shares of The Adams Express Company outstanding as at December 31, 1929, before giving effect to the absorption of the assets of Haygart Corporation, was $32,102,750. To this was added $3,000,000 as the value of the company's leverage. On this basis the total asset value of The Adams Express Company's common stock was determined to be $35,102,750, and the per share asset value of such stock was determined to be $31.41. This asset value determined the issuance of 1.42 shares of The Adams Express Company common stock for each share of Haygart Corporation's common stock. In all, 642,010.4 shares of The Adams Express Company's common stock were issued in exchange for the 452,120 shares of Haygart Corporation common stock (ibid.).

[380] Op. cit. supra, note 347, at 6878, et seq.

[381] After giving effect to the absorption of Haygart Corporation's assets, the total actual asset value of the 1,759,748 shares of The Adams Express Company's common stock outstanding as at December 31, 1929, was $52,341,052. The 642,010 shares which had been issued for the assets of Haygart Corporation had an asset value of $19,095,620 as compared with $20,238,302 of assets transferred to The Adams Express Company. Thus, stockholders of Haygart Corporation suffered an asset loss of approximately $1,143,000, or $2.53 a share of their stock.

[382] See the statistics with reference to the market behavior of nonleverage and leverage common stocks of investment companies in Pt. Two (House Doc. No. 70, 76th Cong.), Ch. IV, pp. 312–15.

facts, may well have differed with their management's appraisal of the value of the leverage in The Adams Express Company's capital structure. Steele Mitchell, of Hayden, Stone & Co., conceded that subsequent events indicated that the "Haygart stockholders should have been paid by The Adams Express stockholders" and that the solicitation letter should have been "more elaborate":[383]

A. As events turned out, it proved to be a much more speculative stock than the Haygart stockholder thought he was receiving at the time of the exchange. Otherwise he would not have been willing to have conceded that the senior money was worth anything.

Q. Looking at it from hindsight, that was probably a pretty bad period to go into a leverage company, wasn't it, because the bottom of the depression was not until 1932. So you increased your [Haygart's] leverage on the way down?

A. As it turned out, and from the policy of the company [The Adams Express Company] the Haygart stockholder should have been paid by the Adams Express stockholder instead of the other way around.

* * * * * * *

Q. I see no mention in here of the leverage characteristic of The Adams Express Company, nor do I see any mention of the $3,000,000 which was paid for the senior money.

A. As I recall, there was no mention of it in that letter.

Q. So that—of either of those factors?

A. Yes.

Q. Don't you think that it might have been better to put that in?

A. In retrospect, as I read the letter over, I think, but it could have been a somewhat more elaborate letter.

Notwithstanding the inadequacy of the information contained in the letter soliciting proxies empowering the management to vote for the sale of Haygart Corporation's assets to The Adams Express Company, the prestige of the firms managing Haygart Corporation, of which most of the stockholders were their customers,[384] was sufficient to enable them to secure proxies to vote over 75% of Haygart Corporation's shares in favor of the sale. The sale of Haygart Corporation's assets was approved by the vote of the holders of 346,609 shares out of the 452,120 shares outstanding. However, the record indicates that no stockholders were present in person at the meeting but that all of the shares voting at the meeting were voted by proxies held by the management of the corporation.[385]

(b) Consolidation of Liberty Bond & Share Corporation, North American Investors Corporation, and Frontier National Corporation to Form Liberty Share Corporation

Another example of the paucity of financial and other information supplied to the stockholders of consolidating investment companies is

[383] Op. cit. supra, note 347, at 6881–2, 6886.

[384] Id., at 6886. Mr. Mitchell testified (ibid.):

> Hayden, Stone, and Hallgarten & Company had sponsored Haygart and they and their friends and their partners and their clients had substantial ownership in the company and it was thought that Hayden, Stone, and Hallgarten, in working out the details of the acquisition would see that Haygart stockholders received equitable treatment.

[385] Id., at 6882–3.

afforded by the consolidation on April 2, 1929, of Liberty Bond & Share Corporation, North American Investors Corporation, and Frontier National Corporation to form the present Liberty Share Corporation.[386]

Liberty Bond & Share Corporation, the oldest of the consolidating companies, was incorporated in New York on March 19, 1926, by the chairman of the board of directors and the president of the Liberty Bank of Buffalo and their associates in the management of the bank.[387] The corporation derived $1,000,000 as the result of the private sale to the stockholders of the Liberty Bank of Buffalo of 10,000 shares [388] of its stock at a price of $100 a share.[389] Since the officers and directors of the Liberty Bank of Buffalo controlled a majority of the bank's stock,[390] presumably the bank's management became the largest stockholders of Liberty Bond & Share Corporation.

By April 2, 1929, the date of the consolidation, Liberty Bond & Share Corporation had gross assets of $4,133,710 and a net worth of $1,400,742.[391] Included in the gross assets of the company were $1,-497,578 of accounts receivable, representing loans made to enable the borrowers to conduct margin trading accounts in securities.[392] Approximately one-half of these loans had been made to officers and directors of the Liberty Bank of Buffalo and of the corporation itself.[393]

North American Investors Corporation, the second of the consolidating companies, was incorporated in New York on August 13, 1926,[394] under the sponsorship of L. G. Ruth & Company, a Buffalo investment banking firm,[395] as an investment company of the general management type.[396] The company's by-laws contained restrictions upon the investments which could be made by the management.[397] L. G. Ruth became president of North American Investors Corporation, and the firm of L. G. Ruth & Company managed the corporation until the date of the consolidation.[398]

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[386] Public Examination, Liberty Share Corporation, Commission's Exhibit No. 867.

[387] Derived from supplementary information supplied the Commission for Liberty Share Corporation.

[388] Op. cit. supra, note 386, Commission's Exhibit No. 867.

[389] Reply to the Commission's questionnaire for Liberty Share Corporation, Pt. I, Item 8.

[390] Op. cit. supra, note 386, at 9001.

[391] Op. cit. supra, note 389, Pt. II, Exhibit A.

[392] Op. cit. supra, note 386, at 8902, 8908, 9197, and Commission's Exhibit No. 868.

[393] Id., at 8909, and Commission's Exhibit No. 868.

[394] Id., at 8892, and Commission's Exhibit No. 867.

[395] Id., at 8895.

[396] *Moody's Manual of Investments, Banks, etc.*, 1929, p. 2788.

[397] These restrictions were in substance that not more than 10% of the company's investments could be placed in a single security, and when the corporation's investments equalled or exceeded 50% of its paid-in capital, then at least 50% of such investments were to be placed in bonds or similar evidences of indebtedness, financial stocks or stocks of insurance companies. In addition, the directors had formulated the following regulations: (1) Only those securities were to be purchased about which reliable information and data could be ascertained relative to the management, history, assets, earnings, and income of the issuer; and (2) investments in each of the following industries were not to exceed 40% of total investments: public utilities; railroad and steamship lines; and banks and insurance companies. Investments in any other line of industry were not to exceed 30% of total investments; investments in the British Empire were not to exceed 40% of all investments; and investments in any other foreign country were not to exceed 20% of all investments (ibid.).

[398] Op. cit. supra, note 386, at 8895, 9197.

On April 2, 1929, the date of the consolidation, the company had a net worth of $949,039 [399] and had outstanding 3,531 shares of preferred stock entitled on liquidation of the company to a priority in the corporate assets to the extent of $50 a share, and 36,283 shares of common stock.[400] The corporation at the same date had made no loans of its funds, and its assets consisted entirely of cash and securities.[401]

Frontier National Corporation, the third of the consolidating companies, was incorporated in New York on October 5, 1928 [402] under the auspices of L. G. Ruth & Company [403] and various directors and officers of the Frontier National Bank of Buffalo.[404] Its securities were sold to the public by L. G. Ruth & Company.[405]

As at April 2, 1929, the date of the consolidation, Frontier National Corporation had a net worth of $845,393 [406] and had outstanding 41,000 shares of capital stock. Except for $100,000 of outstanding call loans, its assets consisted of cash and securities.[407]

Early in 1929, L. G. Ruth & Company ascertained that the management of Liberty Bond & Share Corporation intended to increase the capitalization of that company. Mr. Ruth suggested to the management of Liberty Bank of Buffalo and Liberty Bond & Share Corporation the possibility of a consolidation of Liberty Bond & Share Corporation, North American Investors Corporation, and Frontier National Corporation as a means of increasing the capital under the control of the management of Liberty Bond & Share Corporation.[408] The management of Liberty Share Corporation assented to Mr. Ruth's proposal, and the preparation of the plan and the terms for the consolidation of the three companies was placed in their hands almost exclusively.[409] In fact, Mr. Ruth testified that "the motivating influence or forces surrounding their consolidation was the dominant position of the Liberty Bank of Buffalo, in Buffalo. It was and still is one of the three largest banking institutions by far and well recognized." [410] Moreover, as an aspect of the consolidation plan, it was agreed that Mr. Ruth was to become a vice president of Liberty Bank of Buffalo,

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[399] Op. cit. supra, note 389, Pt. II, Exhibit A.

[400] *Moody's Manual of Investments, Banks, etc.,* 1929, p. 2789.

[401] Op. cit. supra, note 389, Pt. II, Exhibit A. As at January 15, 1929, 49.96% of the company's portfolio consisted of bonds; 5.68% of preferred stock; 23.99% of bank stocks; and 20.37% of common stocks other than bank stocks (*Moody's Manual of Investments, Banks, etc.,* 1929, p. 2789).

[402] Op. cit. supra, note 386, Commission's Exhibit No. 867.

[403] *Moody's Manual of Investments, Banks, etc.,* 1929, p. 1462.

[404] Op. cit. supra, note 386, at 8939–40. Edward J. Meyer, the president of the Frontier National Bank, became president of Frontier National Corporation (*Moody's Manual of Investments, Banks, etc.,* 1929, p. 1462). With the exception of Mr. Ruth, all of the directors of Frontier National Corporation were directors of the Frontier National Bank (ibid.).

[405] Ibid.

[406] Op. cit. supra, note 389, Pt. II, Exhibit A.

[407] Ibid.

[408] Op. cit. supra, note 386, at 8940, and derived from supplementary information supplied the Commission for Liberty Share Corporation. At the same time negotiations were pending to merge Frontier National Bank into Liberty Bank of Buffalo (op. cit. supra, note 386, at 8940). This merger occurred in June 1929 (*Moody's Manual of Investments, Banks, etc.,* 1931, p. 224).

[409] Derived from supplementary information supplied the Commission for Liberty Share Corporation.

[410] Op. cit. supra, note 386, at 9199.

a position which, although it involved no increase in Mr. Ruth's existing salary, nevertheless enhanced his prestige and reputation in Buffalo. Mr. Ruth testified:[411]

Q. Part of the merger agreement was that you were getting a job as vice president of the bank, wasn't it?

A. That was a part of the—not that I was to get a job, Mr. Smith, because I was making a real sacrifice when I took that job, from the point of view of salary.

Q. You got more prestige, though, didn't you as a vice president of the bank?

A. I think I considered that.

Q. Bank vice presidents were pretty prominent people in those days, weren't they?

A. Yes.

The plan of consolidation, as prepared by the management of Liberty Bank of Buffalo and Liberty Bond & Share Corporation and accepted without dissent[412] by Mr. Ruth and his associates in the management of Frontier National Corporation and North America Investors Corporation, was highly favorable to the stockholders of Liberty Bond & Share Corporation.

Under the plan a new corporation known as Liberty Share Corporation was to be organized and was to issue 232,571¼ shares[413] of its capital stock for the $3,195,174 of net assets of the three consolidating companies.[414] Each of the 232,571¼ shares of the new company's stock which were to be issued thus possessed an asset value of $13.73 a share. The new company was to issue its stock to the stockholders of the three consolidating companies in the following ratios: for each share of the stock of Liberty Bond & Share Corporation which had an asset value of $140.07 a share, 15 shares of the stock of the new company with an asset value of approximately $206 were to be issued; for each share of the stock of Frontier National Corporation possessing an asset value of $20.62 a share, four-fifths of a share of the stock of the new company with an asset value of $10.98 were to be issued. Both the preferred and the common stock of North American Investors Corporation were to be treated alike; no consideration was given to the preferences accorded to the preferred stock. For each share of the preferred stock of North American Investors Corporation having a liquidating value of $50 a share, and for each share of the common stock of North American Investors Corporation having an asset value of $21.27, there were to be issued 1¼ shares of the new company's stock having an asset value of $17.16.[415]

From these figures it is clear that the plan contemplated a substantial increase in the asset position of the stockholders of Liberty Bond & Share Corporation at the expense of the stockholders of North American Investors Corporation and of Frontier National Corporation. Moreover, the plan contemplated that the new com-

[411] Id., at 9200–1.

[412] Id., at 9188.

[413] Derived from supplementary information supplied the Commission for Liberty Share Corporation.

[414] Op. cit. supra, note 389, Pt. II, Exhibit A.

[415] Op. cit. supra, note 386, Commission's Exhibits Nos. 867, 891.

pany would be controlled by the stockholders of the former Liberty Bond & Share Corporation. Although only $1,400,742, or less than 50% of the $3,195,173 of net assets to be transferred to the new company by the three consolidating companies, was contributed by the stockholders of Liberty Bond & Share Corporation, its stockholders received 150,000 shares, or approximately 65%, of the 232,571¼ shares of the stock of Liberty Share Corporation to be issued to the stockholders of the consolidating companies.[416] In fact, until 1933 [417] 14 of the 16 directors of Liberty Share Corporation were directors and officers of Liberty Bank of Buffalo.[418] Liberty Share Corporation until 1933 functioned largely as a security affiliate of the Liberty Bank of Buffalo.[419]

Philip H. Gerner, an officer and director of Liberty Bank of Buffalo and of Liberty Bond & Share Corporation, testified that the larger participation in the assets of the consolidated company awarded under the plan to the stockholders of Liberty Bond & Share Corporation was "more or less arbitrary." [420] He testified that the plan was based on the superior earnings record of Liberty Bond & Share Corporation, as compared to those of the other consolidating companies, the larger premium over asset value at which the stock of Liberty Bond & Share Corporation was selling in the market, and the fact that the stockholders of North American Investors Corporation and of Frontier National Corporation would benefit by a stock interest in a new company which would be supplied investment opportunities by Liberty Bank of Buffalo.[421] However, as Mr. Ruth

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[416] Derived from supplementary information supplied the Commission for Liberty Share Corporation. At the date of the consolidation, stockholders of the consolidating corporation received rights to purchase additional shares of the new company's stock at a price of $30 a share. Stockholders of North American Investors Corporation acquired the right to purchase 2 additional shares for each 5 shares of the new company stock acquired in exchange for the stock of their old company; stockholders of Frontier National Corporation acquired the right to purchase 1 additional share of the new company's stock for each 4 shares of that company's stock acquired in the consolidation; and stockholders of Liberty Bond & Share Corporation received the right to purchase 1 additional share of the new company's stock for each 2 shares of such stock acquired as the result of the consolidation. As a result of the exercise of these rights, stockholders of North American Investors Corporation purchased an additional 19,908½ shares and stockholders of Frontier National Corporation purchased an additional 8,200 shares of the stock of Liberty Share Corporation. The stockholders of Liberty Bond & Share Corporation on the exercise of their rights, however, acquired 75,000 additional shares of the stock of Liberty Share Corporation (ibid. and op. cit. supra, note 386, Commission's Exhibits Nos. 867 and 891). Finally, Liberty Share Corporation offered an additional 114,320¼ shares of its stock to various directors and officers of Liberty Bank of Buffalo, the consolidating companies, and to others, at a price of $30 a share (op. cit. supra, note 386, Commission's Exhibit No. 877). As a result of the consolidation, the sale of its stock to the stockholders of the consolidating companies and others, Liberty Share Corporation had acquired net assets of $9,718,036 and had issued therefor 450,000 shares of its capital stock. However, the stockholders of Liberty Bond & Share Corporation who had contributed a total of $3,650,-742, or approximately 40% of its net assets, to Liberty Share Corporation received as consideration therefor 225,000 shares or 50% of the stock of Liberty Share Corporation.

[417] The Banking Act of 1933 (12 U. S. C. A. §378) compelled officers and directors of banks which were members of the Federal Reserve System to sever their relationships with security affiliates (id., at 8909 and 8936–7). After the passage of this Act, 11 of the 16 directors of Liberty Share Corporation who were also officers and directors of the Liberty Bank resigned as directors of Liberty Share Corporation (ibid.).

[418] Id., at 8909.

[419] Op. cit. supra, note 389, Pt. I, Item 9.

[420] Op. cit. supra, note 386, at 9187–8.

[421] Id., at 9186–8.

conceded, the connection of Liberty Share Corporation with Liberty Bank of Buffalo actually proved to be of no value. Under the management of Liberty Bank of Buffalo the value of the assets of Liberty Share Corporation, the consolidated company, declined from $10,410,722, the total capital contributed to the company by its stockholders, to $712,936 at September 30, 1936.[422] Mr. Ruth testified:[423]

A. Well, I think that the big point that was the motivating influence or force surrounding this consolidation was the dominant position of the Liberty Bank of Buffalo, in Buffalo. It was and still is one of the three largest banking institutions, by far, and well recognized.

Q. And you thought that out of that aura of prominence there would be some benefit; is that right?

A. Not only prominence, but I think that it is a fair statement to make that not only was the bank prominent, but it had a long record of success.

Q. So that a large part of the premium which your shareholders [the stockholders of North American Investors Corporation and Frontier National Corporation] paid, was for this affiliation with this management.

A. It was potential value.

Q. And it turned out in fact to be a gold brick.

A. It didn't turn out to be of potential value. * * *

One of the "very prominent causes"[424] of the shrinkage in assets of Liberty Share Corporation were losses[425] suffered on loans made to officers and directors of the corporation and of Liberty Bank of Buffalo to enable them to trade in securities, particularly the stock of Liberty Bank of Buffalo.[426] This practice, it will be recalled, had been prevalent in Liberty Bond & Share Corporation, one of the predecessors of Liberty Share Corporation. Mr. Ruth testified[427] that although he was aware of the fact that in excess of one-third of the gross assets of Liberty Bond & Share Corporation represented loans made by that corporation, he, as the representative of North American Investors Corporation, had made no attempt to ascertain the nature of these loans prior to the consolidation of the companies:

Q. And at that time, or prior to the date of consolidation, did you know of this $1,400,000 worth of margin accounts which were included among the assets of the Liberty Bond & Share Corporation?

A. No; I didn't.

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[422] Id., at 8896–8.

[423] Id., at 9199–200.

[424] Id., at 8899.

[425] As at December 31, 1929, loans made by Liberty Share Corporation to its own officers and directors and to officers and directors of Liberty Bank of Buffalo totaled $2,306,485. As at December 31, 1930, such loans totaled $4,191,297. At December 31, 1932, these loans totaled $2,875,600, and at the end of 1933 such loans totaled $2,996,303. During 1934, these loans were transferred by Liberty Share Corporation to Casterlan Corporation, a company formed for the purpose of liquidating such loans (id., at 8929). As at May 22, 1936, Casterlan Corporation held obligations of existing and former officers and directors of Liberty Share Corporation and Liberty Bank of Buffalo in the face amount of $3,397,113, secured by collateral having a then market value of $479,635 (id., Commission's Exhibit No. 875). In other words, on these loans an unrealized loss of $2,921,769 had been incurred.

[426] Id., at 8948.

[427] Id., at 9197–8.

Q. You knew their accounts payable were there?

A. Yes.

Q. But you didn't know that they were margin accounts?

A. I didn't know the details of it.

Q. Did you know that they were margin accounts?

A. No.

Q. And did you know that half of those accounts were margin accounts in which officers and directors of the bank or Liberty Bond & Share were involved?

A. No, sir.

Q. Do you know whether the president of the Frontier National knew of that information?

A. I don't know.

* * * * * * *

Q. What information——

A. I am not indicating, however, that I couldn't have found out, and if I didn't know it, perhaps I am just as much to be criticized as anyone, as I view it now.

Q. You relied, didn't you, upon the names of the men who were involved; is that it?

A. Well, I think that that is a fair assumption. I think that 99 percent of the people of the City of Buffalo would have done the same thing.

On March 18, 1929, the respective managements of the consolidating companies mailed identical letters [428] to their stockholders informing them of the impending consolidation and soliciting their proxies to be voted in favor of the consolidation by their managements. Although most of the stockholders of the three companies were residents of Buffalo, in which city the meetings to pass on the plan of consolidation were to be held, the stockholders of the three companies were not requested to attend the meetings personally. Instead, they were requested to transmit to their respective managements, proxies to vote their shares in favor of the consolidation.

Nor were the letters accompanied by financial statements of any of the companies or of the consolidated company. No balance sheets or income statements of the companies were included in the literature used to solicit proxies. Philip L. Gerner, an officer and director of Liberty Bank of Buffalo and the first president of Liberty Share Corporation, testified: [429]

Q. They [the letters soliciting proxies] ask for a blank delegation to somebody appointed by the directors or the management on the inside. There is nothing * * * which gives either the comparative book [asset] value or a comparative statement of their earnings or any statement as to the liabilities, relative assets and liabilities. In fact, there are no figures, are there?

A. Not to the stockholders; no, sir.

* * * * * * *

Q. Is there anything upon which an intelligent investor could make his decision as to whether to give his proxies, other than to rely upon the good faith of the people that are involved. He was asked to sign the proxy upon the good faith of the people?

A. He relied on the people involved; that is right.

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[428] Id., Commission's Exhibit No. 891.

[429] Id., at 9192, 9196.

As a result, the stockholders of North American Investors Corporation and of Frontier National Corporation were not informed of the losses in asset values which they would suffer if they accepted the plan. The stockholders of North American Investors Corporation, a company which had restrictions upon the investment policies which might be pursued by its management, were not informed of the fact that the charter and bylaws of Liberty Share Corporation contained no limitations upon the investment policies which its management might adopt.[430] The stockholders of Frontier National Corporation and of North American Investors Corporation were not informed of the fact that, in contrast to their own companies whose assets consisted almost entirely of cash and securities, a substantial portion of the assets of Liberty Bond & Share Corporation consisted of accounts receivable due from the officers and directors of Liberty Bank of Buffalo and of the investment company itself. Mr. Ruth characterized these omissions of material facts as the "usual practice of the times": [431]

Q. Now, also, you sent out a page and a half letter of solicitation to your stockholders. You didn't disclose any information to them upon which they could consider the fairness of the transaction. All that you did was to say that you were in favor of it and "please send in your proxy."

A. I think that we followed the usual practice of the times, that we indicated——

Q. But that is what you did?

A. That is what we did, which was the usual thing.

On April 2, 1929, the consolidation was approved by the more than 2,700 stockholders of the three companies without a dissenting vote. However, only about 25 stockholders personally appeared at the meetings.[432] Thus the consolidation was in effect approved by the managements of the three companies who had obtained proxies to vote the shares of the vast majority of the stockholders of the three companies.

c. Market Operations in Securities of Merging Companies

In addition to their control of the preparation of the literature used to solicit proxies, managements have employed other devices to make their plans for mergers, consolidations, and sales of the entire corporate assets seem attractive to stockholders. Managements can cause their corporations to purchase their own securities in order to stabilize or to increase artifically the market value of such securities. The rising market quotations for and the increased market volume of trading in, the securities affected by a plan of merger or consolidation during the interim between the announcement of the plan and the stockholders' meetings to pass upon the plan, will suggest that the plan has been approved by investors generally and clearly will have a

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[430] Id., Commission's Exhibit No. 867.
[431] Id., at 9201.
[432] Id., at 9188, 9193–4.

tendency to induce stockholder assents to the plan.[433] In the past,[434] manipulation or stabilization of the market prices of the securities of merging investment companies in order to induce the assent of their stockholders to the consummation of the plan of merger has not been uncommon.[435] The artificial increase of the market price of the stock of The Goldman Sachs Trading Corporation because of that corporation's own market purchasing activities, as an incident to its purchase in 1929 of all the assets of Financial and Industrial Securities Corporation is illustrative of this practice.

(1) SALE OF ASSETS OF FINANCIAL AND INDUSTRIAL SECURITIES CORPORATION TO THE GOLDMAN SACHS TRADING CORPORATION

Financial and Industrial Securities Corporation was organized in Maryland on December 24, 1925,[436] largely as a holding company for substantial blocks of the voting stock of the Manufacturers Trust Co. (New York, N. Y.), National Liberty Insurance Co. of America, Baltimore American Insurance Co. of New York, and Peoples National Fire Insurance Co. of Delaware previously owned by Ralph Jonas and his associates.[437] As at December 31, 1928, the corporation had total assets of $111,000,000[438] and had outstanding approximately 1,700,000 shares of capital stock[439] of which

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[433] "While a corporation may have legal 'power' to trade in its own stock its 'purposes' are certainly not that. In theory the corporate capital is to be used for other business purposes, trading in its own stock being only incidental and contemplated only in connection with some other corporate activity. The purchaser of the stock at the pegged level is, it would seem, entitled to assume that this is the level which outsiders in the market are at present buying the stock; certainly, were he informed that the real buyer at that level was the corporation, his appraisal of the security might be radically changed." Berle, "Liability for Stock Market Manipulation" (1931), 31 Columbia Law Review 264, 276. For a detailed discussion of the repurchases of their own securities by investment companies, see Ch. III of this part of the report, pp. 953–1015.

[434] Section 9 (a) (2) of the Securities Exchange Act of 1934 makes it unlawful for any person "to effect alone or with one or more persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others." Section 9 (a) (6) of the same act makes it unlawful for any person "to effect either alone or with one or more other persons any series of transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

These sections, however, apply only to securities listed on national securities exchanges. As has been indicated in Ch. IV of Part Two (House Doc. No. 70, 76th Cong.) of this report, securities of a substantial number of investment companies are not listed on exchanges but are traded in only over the counter. Under the provision of Section 15 (c) of the Securities Exchange Act of 1934, the manipulation of over-the-counter securities by "brokers and dealers" only is proscribed.

[435] Compare the stabilization of the market prices of the common stock of The Equity Corporation and of Atlas Corporation during the pendency of their exchange offers for the securities of their controlled companies, discussed supra, pp. 1373–83.

[436] Public Examination, Financial and Industrial Securities Corporation, Commission's Exhibit No. 2096.

[437] See Part One (House Doc. No. 707, 75th Cong.), Ch. III, pp. 90–1; op. cit. supra, note 436, at 18900, and Commission's Exhibit No. 2097.

[438] Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1679.

[439] Ibid. Financial and Industrial Securities Corporation had originally had an issue of preferred stock outstanding which, however, had been called for redemption on December 31, 1928 (op. cit. supra, note 436, Commission's Exhibit No. 3008).

approximately 750,000 shares or 45 percent of the total were owned beneficially by Ralph Jonas.[440] By far the largest part of the assets of Financial and Industrial Securities Corporation consisted of its holdings of 32 percent of the capital stock of the Manufacturers Trust Co.; 47 percent of the stock of National Liberty Insurance Co. of America; 33 percent of the stock of Baltimore American Insurance Co. of New York, and 49 percent of the stock of Peoples National Fire Insurance Co. of Delaware,[441] hereinafter referred to as the "National Liberty group" of insurance companies.

In September of 1928, Sidney J. Weinberg, a partner in the New York investment banking firm of Goldman, Sachs & Co. informed Nathan Jonas, a brother of Ralph Jonas, and the president of Manufacturers Trust Co., that Goldman, Sachs & Co. would like "to take an interest" in the bank.[442] Nathan Jonas referred Goldman, Sachs & Co. to his brother, Ralph Jonas, the chairman of the board of directors and largest stockholder of Financial and Industrial Securities Corporation which, as has been stated, then owned approximately 32 percent of the stock of the bank, a block of stock sufficient to constitute working control of the bank.[443]

Ralph Jonas suggested that Goldman, Sachs & Co. "take a substantial position in Financial and Industrial Securities Corporation."[444] This proposition, however, Goldman, Sachs & Co. refused to consider on the ground that it preferred to form its own investment company.[445]

On December 4, 1928, Goldman, Sachs & Co. caused The Goldman Sachs Trading Corporation to be incorporated in Delaware with an authorized capitalization of 2,500,000 shares of capital stock, all of one class and without par value.[446] Goldman, Sachs & Co. on the same day entered into a mangement contract[447] with the new company which granted to the investment banking firm the exclusive right to manage the affairs of the corporation for a period of 10 years.[448] All of the partners of the firm of Goldman, Sachs & Co.

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[440] Op. cit. supra, note 438, at 16281–2.

[441] Id., at 14950–1, and Commission's Exhibit No. 1667. The total market value of the securities of the bank and the three insurance companies held by Financial and Industrial Securities Corporation as at February 21, 1929, the date of the sale of its assets to The Goldman Sachs Trading Corporation was approximately $88,000,000, or 75% of its then total assets of $117,500,000 (id., Commission's Exhibit No. 1683).

[442] Id., at 16269–70.

[443] Waddill Catchings, who in 1929 was the senior partner in Goldman, Sachs & Co. (id., at 15862), denied that a 32% interest in the stock of the bank would constitute "control" (id., at 15946–7). However, Harvey D. Gibson, the present president of Manufacturers Trust Company, who, with associates, purchased the bulk of The Goldman Sachs Trading Corporation's holdings of the stock of Manufacturers Trust Company in January 1931 (id., at 17483 et seq.), conceded that a 32% interest in the stock of the bank was "working control."

> Q. You take The Goldman Sachs Trading Corporation which owned 32% of the total outstanding stock of the bank directly or indirectly either through itself or through its insurance companies, and that is virtually control, isn't it?
> A. That is working control, there is no doubt about it * * * (id., at 17507–8).

[444] Id., at 16271.

[445] Id., at 16269–72.

[446] Id., at 15862, and Commission's Exhibit No. 1652.

[447] Id., Commission's Exhibit No. 1654.

[448] However, the contract could be terminated at any time by the vote of the holders of a majority of The Goldman Sachs Trading Corporation's shares (ibid.).

constituted all of the directors of The Goldman Sachs Trading Corporation.[449]

By January 31, 1929, the corporation had issued 1,125,000 shares of its capital stock for which it had received a total consideration of approximately $115,000,000.[450] Goldman, Sachs & Co. had acquired 100,000 shares of the investment company's stock at a cost of $1,000,000.[451]

Financial and Industrial Securities Corporation purchased 49,000 shares of the stock of The Goldman Sachs Trading Corporation at $102 a share, the price at which the stock was offered to the group of dealers which distributed the securities of The Goldman Sachs Trading Corporation.[452] The importance of these holdings of The Goldman Sachs Trading Corporation stock by Financial and Industrial Securities Corporation in the development of the plans to combine the two companies will appear later.

The prospectus issued in connection with the sale of the securities of The Goldman Sachs Trading Corporation stated that its purposes were to buy, sell, trade in, or hold stocks and securities of any kind; to participate in syndicates and underwritings; and to exercise such other of its charter powers as its board of directors may from time to time determine.[453] The statement gave no inkling of any intention upon the part of the company's management to invest its funds for the purpose of acquiring control of, or substantial security interests in financial or other institutions.[454] On the contrary, the name of the corporation suggested that its principal purpose would be to trade in securities. In fact, in a letter [455] to the group of dealers who had sold the investment company securities to the public, it was stated that the company would have "in general the purposes of a trading investment trust." Presumably this information was communicated by the dealers to their customers. Similarly, in a letter [456] written by Goldman, Sachs & Co. to the New York Stock Exchange prior to the formation of the investment company it was stated that the firm proposed to form a corporation "whose principal object would be to trade in securities."

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[449] The management contract between the banking firm and The Goldman Sachs Trading Corporation required all directors of the corporation to be approved by Goldman, Sachs & Co. (ibid.).

[450] Id., Commission's Exhibit No. 1657.

[451] Id., Commission's Exhibit No. 1656. For a more detailed discussion of the public distribution of the stock of The Goldman Sachs Trading Corporation see Ch. III of this part of the report, pp. 922–8.

[452] Op. cit. supra, note 438, at 16294–5.

[453] Id., Commission's Exhibit No. 1656.

[454] Nevertheless, by September 1929, within 10 months after the organization of The Goldman Sachs Trading Corporation, approximately 75% of its then assets of approximately $326,000,000 (id., at 16077–80) was invested directly or through subsidiaries in either controlling or influential blocks of the stock of 5 commercial banks and their security affiliates (2 situated in New York, 1 in Philadelphia, 1 in Chicago, and 1 in San Francisco); 3 investment companies; 3 fire insurance companies; a life insurance company; 3 investment banking corporations; 2 department stores; a real estate development company; a barge line operating on the Misssissippi River; a mortgage company; a company engaged in the exploitation of frozen food products; and a milk products company (id., Commission's Exhibit No. 1667). The total resources of these various enterprises in which The Goldman Sachs Trading Corporation had substantial security interests as at December 31, 1929, was approximately $1,700,000,000 (id., Commission's Exhibit No. 1671).

[455] Id., Commission's Exhibit No. 1674.

[456] Id., Commission's Exhibit No. 1673.

Mr. Catchings testified that the purpose of The Goldman Sachs Trading Corporation was to "give the clients and customers of Goldman, Sachs & Co. the same kind of opportunity of making money which Goldman, Sachs & Co. as a firm had given to its clients and customers in previous years." [457] Mr. Catchings testified: [458]

Q. What was the experience of Goldman, Sachs & Company which impelled you to bestow the same favor upon anyone of the American public who would buy shares of The Goldman Sachs Trading Corporation stock that you had bestowed on your other clients?

A. Throughout the whole period of time of ins and outs and ups and downs of business, Goldman, Sachs & Company had managed to select for issue to the public securities which on the whole had turned out to be very satisfactory investments, and it was the opinion of the firm that if an investment and trading company was formed which would engage in somewhat the same kind of investment policies as large individuals engaged in connection with securities issued by Goldman, Sachs, that it would be a beneficial thing to do.

* * * * * * *

Q. Then, based on your experience you were organizing this investment trust in the hope that you would be able to duplicate the performance of your client by following the same investment policy, namely, investing in the same type of stocks that you had sold to your clients as a banking firm?

A. I don't think we had any anticipation that the record would have been made during a period when a great many private companies were becoming public companies, and there was a great increase in industrial and commercial activities—that that was the necessary pattern of what would happen in the future, but we all felt that we would continue to be able to select enterprises which in their early stages offered such terms, under such able management, because our whole policy had been to issue securities where the management was a well-tried management and knew what it was about, and in issuing that type of securities these men were successful over a period of time, and the investor made money.

Mr. Catchings further testified: [459]

* * * other banking houses had formed investment and trading companies and more were doing it, and we felt it was a wise thing for Goldman, Sachs & Company, as a firm, to afford to its clientele the same type of investment opportunity and service which every house was affording to their clientele.

However, despite the at least semipublic declarations of a policy of The Goldman Sachs Trading Corporation to "trade in securities," Goldman, Sachs & Co. in January 1929 again approached Ralph Jonas to negotiate for an amalgamation with The Goldman Sachs Trading Corporation of Financial and Industrial Securities Corporation, substantially all of the assets of which, as has been stated, consisted of controlling blocks of the stocks of Manufacturers Trust Company and of the National Liberty group of fire-insurance com-

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457 Id., at 15888.
458 Id., at 15889–94.
459 Id., at 15897.

panies.[460] The absorption of Financial and Industrial Securities Corporation by The Goldman Sachs Trading Corporation was to be accomplished ultimately by an exchange of The Goldman Sachs Trading Corporation's shares for those of Financial and Industrial Securities Corporation.

Although Mr. Catchings denied that the firm of Goldman, Sachs & Co. had any personal interest[461] in the contemplated absorption by The Goldman Sachs Trading Corporation of the assets of Financial and Industrial Corporation, he admitted that banks[462] and insurance companies were "big purchasers"[463] of securities from investment banking firms and others. And from February 21, 1929, the date that the assets of Financial and Industrial Securities Corporation were acquired by The Goldman Sachs Trading Corporation, the firm of Goldman, Sachs & Co., which, as has been indicated, controlled the management of The Goldman Sachs Trading Corporation,[464] sold approximately $20,000,000[465] of securities to the Manufacturers Trust Company and to the National Liberty group of insurance companies.

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[460] Waddill Catchings, the senior partner of Goldman, Sachs & Co. and president of The Goldman Sachs Trading Corporation, testified that the purpose of the acquisition through Financial and Industrial Securities Corporation of the stock of the bank and the insurance companies was to resell a large proportion of such stock at a profit after the earnings of the companies had increased as the result of the efforts of The Goldman Sachs Trading Corporation and of Goldman, Sachs & Co. to "build them up" (id., at 16502), a procedure which he characterized as "trading" within the meaning of the word as used in the letters to the New York Stock Exchange and to the dealers who had sold the investment company's securities to the public (id., at 16098–16100).

[461] Id., at 15899–90. Mr. Catchings testified (id., at 16631):

> Q. I suppose you today reiterate your * * * previous assertion that the directors of The Goldman Sachs Trading Corporation weren't even remotely interested in acquiring the insurance companies because of their potential purchasing power of securities in which Goldman, Sachs & Company were the bankers; is that it?
>
> A. Yes; I say exactly what I said before. I think the word "remotely" isn't involved in what I said before, but with a proper understanding of the word "remotely," I say, "yes."

[462] Mr. Catchings testified that "a bank such as the Manufacturers Trust Company, of this size might posssibly at times have been a large buyer of securities * * *" (id., at 15954).

[463] Mr. Catchings testified that "I think we can say with regard to insurance companies that they are what you would call 'big purchasers' of securities" (id., at 15962).

[464] Immediately after The Goldman, Sachs Trading Corporation acquired control of the Manufacturers Trust Company and of the National Liberty group of insurance companies, Messrs. Waddill Catchings, Walter Sachs, and Sidney J. Weinberg of Goldman, Sachs & Co. became members of the boards of directors of these companies (id., at 15948, 16644–9). In the case of the Manufacturers Trust Company, 13 of its 30 directors either were partners in the firm of Goldman, Sachs & Co. or were directors and officers of banking clients of that firm (id., at 16020–24). Mr. Catchings testified that "we did exercise a considerable influence in the Manufacturers Trust Company" (id., at 15949) and that "Goldman, Sachs & Company did * * * suggest favorable investment opportunities to the officials of the National Liberty group of insurance companies for their consideration" (id., at 16637).

[465] Id., Commission's Exhibits Nos. 1663 and 1664. The dollar amount of the sales of securities made by Goldman, Sachs & Co. to the bank and 3 insurance companies during 1929 was as follows (ibid.):

Manufacturers Trust Company	$16, 122, 602. 86
National Liberty Insurance Company	2, 611, 993. 08
Baltimore American Insurance Company	774, 131. 25
Peoples National Fire Insurance Company	342, 887. 50

Of the $16,122,602.86 of securities sold by Goldman, Sachs & Co. to Manufacturers Trust Company, approximately $12,000,000 represented participation by the bank in underwriting syndicates headed by Goldman, Sachs & Co. or in which Goldman, Sachs & Co. as a

During the course of the negotiations in January 1929 for the acquisition by The Goldman Sachs Trading Corporation of the assets of Financial and Industrial Securities Corporation, the market price of the stock of The Goldman Sachs Trading Corporation on the New York Curb Exchange ranged from $117 to $136 per share; its asset value ranged from $100 to approximately $108 per share.[466] The market value of the stock of Financial and Industrial Securities Corporation as quoted over the counter[467] during the month of January 1929 ranged from $133 to $143 a share, although the asset value of the stock was between $70 and $80 per share.[468]

Because of the greater disparity between the market and asset value of the stock of Financial and Industrial Securities Corporation, an exchange of shares of the two corporations on the basis of their market values would result in a large dilution in the existing participation in the assets of their company by the stockholders of The Goldman Sachs Trading Corporation. For example, on the basis of a

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participant had reallocated a portion of its participation to the bank (id., at 15977 and Commission's Exhibits Nos. 1663 and 1664).

In addition to its participation in underwriting syndicates with Goldman, Sachs & Co., the Manufacturers Trust Company also participated with Goldman, Sachs & Co. and others in accounts formed by Goldman, Sachs & Co. in September and December 1929, to trade in the stock of The Goldman Sachs Trading Corporation (id., Commission's Exhibits Nos. 1692 and 1693). On its participation in these accounts, the bank suffered losses in excess of $1,000,000 (id., at 16364–5 and Commission's Exhibits Nos. 1692 and 1693). When questioned with reference to the participation of the bank in these trading accounts, Mr. Catchings testified (id., at 16357):

> Q. You had no feeling of hesitation about asking the Manufacturers Trust Company which was a commercial bank and which had on deposit the public's funds, to participate in an account which was speculating in Goldman Sachs Trading Corporation stock?
> A. I hadn't the slightest question about asking them in, and I haven't got it now. I think it was an entirely proper thing for them to do, if they want to do it.

Harvey D. Gibson, the present president of the Manufacturers Trust Company, who with associates purchased the bulk of The Goldman, Sachs Trading Corporation's holding of the stock of the Manufacturers Trust Company in January 1931 (id., at 17481, et seq.) testified as follows with reference to the securities contained in the bank's portfolio at that date (id., at 17499–17500):

> Q. Did you find in the portfolio of the bank substantial blocks of securities of companies which were affiliated with The Goldman Sachs Trading Corporation?
> A. Oh, yes; that is true.
> Q. What do you mean by "affiliated"? Maybe we are not using the same expression.
> A. Well, securities of which they had blocks and in which they had been active in distributing to the public.
> Q. Securities like Shenandoah [Corporation]?
> A. Shenandoah, Blue Ridge.
> Q. The Goldman Sachs Trading Corporation?
> A. And The Goldman Sachs Trading Corporation, large blocks of these securities.
> Q. And from these affiliated companies, did you have a sense of awareness that the portfolio of Manufacturers Trust Company included a substantial amount of securities of corporations for whom Goldman, Sachs & Company had acted as bankers?
> A. Yes; in a considerable amount.

Prior to 1929, the portfolio of the National Liberty Insurance Company and Baltimore American Insurance Company consisted primarily of holdings of the stock of Manufacturers Trust Company (id., at 16631 and Commission's Exhibits Nos. 1714–5). By the end of 1929, the portfolios of these companies included, in addition to the stock of the Manufacturers Trust Company, securities of 24 companies who were banking clients of Goldman, Sachs & Co. (id., at 16635, et seq.).

[466] The original agreement for the purchase of the assets of Financial and Industrial Securities Corporation by The Goldman Sachs Trading Corporation placed the asset value of The Goldman Sachs Trading Corporation's assets at $122,000,000 or approximately $108 per share for each of its outstanding 1,125,000 shares (id., Commission's Exhibits Nos. 1665, 1679).

[467] The stock of Financial and Industrial Securities Corporation was not listed on any securities exchange.

[468] Op. cit. supra, note 438, at 16273.

market value at the end of January 1929 of $143 for the stock of Financial and Industrial Securities Corporation and a market value of $136 for the stock of The Goldman Sachs Trading Corporation, an exchange of the shares on the basis of market value would result in the receipt by the stockholders of Financial and Industrial Securities Corporation of approximately 1.05 shares of the stock of The Goldman Sachs Trading Corporation having an asset value before the combination of the two companies of approximately $113.40 in exchange for each of their shares of the stock of Financial and Industrial Securities Corporation which possessed an asset value of between $70 and $80 a share.

As a consequence, in all the negotiations for the acquisition of the assets of Financial and Industrial Securities Corporation by The Goldman Sachs Trading Corporation, Waddill Catchings, the president of The Goldman Sachs Trading Corporation and the leading partner in Goldman, Sachs & Co.[469] took the position "that any discussion would have to be predicated upon asset values." However, Mr. Jonas at least initially contended that market values would have to be considered in determining the basis for the exchange of the shares of the two companies. Because of this difference in viewpoint the negotiations were abandoned for a time. Mr. Jonas testified:[470]

A. * * * There had been some discussion of a possible basis of combination and Mr. Catchings took the position that any discussion would have to be predicated on asset values.

Q. What was your thought?

A. In the initial stages we felt there should be some consideration for the market viewpoint, and the discussions broke off because of that difference in viewpoint, and after discussing the matter with my associates, we felt that it would be desirable even on the basis of an asset position to make a combination of interests between the F. and I. [Financial and Industrial Securities Corporation] and The Goldman Sachs Trading Corporation, and the discussions were continued on that basis and as a result of the change of position on our part the negotiations were consummated along those lines.

As a result of Mr. Jonas' agreement to discuss the combination of the two companies on the basis of asset value, negotiations were resumed on January 29, 1929, and on February 3, 1929, the parties had reached a tentative oral agreement[471] for the combination of the two companies upon an asset value basis in the following manner: For the purpose of the transaction the assets of The Goldman Sachs Trading Corporation were valued at $122,000,000 and the assets of Financial and Industrial Securities Corporation were valued at $111,000,000. Financial and Industrial Securities Corporation was to increase its assets to $122,000,000 by offering to its stockholders

[469] Mr. Catchings severed his connection with the firm of Goldman, Sachs & Co. and with The Goldman Sachs Trading Corporation in May 1930.

[470] Op. cit. supra, note 438, at 16272–3.

[471] Mr. Catchings testified that the only thing that was certain about the oral agreement of February 3, 1929, was that the companies would be combined on an asset value basis (id., at 16189). In fact, the actual mechanics for the consummation of the transaction were not worked out until February 6, 1929 (ibid.). As will be seen infra, the substantial market purchase of its own stock by The Goldman Sachs Trading Corporation was an important factor in the alteration of the plans of the parties. The oral agreement of February 3, 1929, was transformed into a written agreement on February 6, 1929 (Id., Commission's Exhibit No. 1679).

550,000 shares of its stock at $20 a share. At the conclusion of this offering of its own stock in addition to bringing the value of its assets to a parity with those of The Goldman Sachs Trading Corporation, Financial and Industrial Securities Corporation's existing outstanding 1,700,000 shares of stock would be increased to 2,250,000 shares. The Goldman Sachs Trading Corporation thereafter would increase its existing 1,125,000 shares to 2,250,000 shares by the declaration of a 100% stock dividend or expressed in another way, by a two for one "stock split up" [472] of its existing shares, and would issue for all of the assets of Financial and Industrial Securities Corporation an additional 2,250,000 shares of stock of The Goldman Sachs Trading Corporation. Financial and Industrial Securities Corporation after these transactions would dissolve and distribute the 2,250,000 shares of The Goldman Sachs Trading Corporation which it had received in exchange for all of its assets, share for share to the holders of the 2,250,000 shares of the stock of Financial and Industrial Securities Corporation.[473] At the conclusion of those proposed transactions, The Goldman Sachs Trading Corporation would have assets of $244,000,000 and have outstanding 4,500,000 shares of stock of which 2,250,000 shares would be held by the stockholders of The Goldman Sachs Trading Corporation prior to the combination of the companies, and 2,250,000 shares would be held by the former stockholders of Financial and Industrial Securities Corporation.

Although Mr. Jonas as the owner of approximately 745,000 shares of the stock of Financial and Industrial Securities Corporation would become the largest stockholder of the combined company,[474] the agreement further provided that Goldman, Sachs & Co. was to obtain a management contract with the combined company on terms identical with its existing contract with The Goldman Sachs Trading Corporation [475] and that the six partners in that firm [476] were to be six of the seven directors of the combined company. The other director was to be Ralph Jonas.[477] However, one of the reasons which apparently impelled Mr. Jonas to combine Financial and Industrial Securities Corporation with The Goldman Sachs Trading Corporation and to accede to the placing of the management of the combined company in Goldman, Sachs & Co. was the fact that Mr. Jonas and his associates were physically incapable of continuing to manage Financial and Industrial Securities Corporation.[478]

Although Mr. Catchings and Mr. Jonas, as the heads of their respective companies, had agreed on a tentative plan for their combination, a sale of all of the assets of Financial and Industrial Securities Corporation to The Goldman Sachs Trading Corporation would require the approval of the holders of a majority of its outstanding

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[472] Id., at 15869 and Commisssion's Exhibit No. 1687 (p. 4).

[473] Id., Commission's Exhibit No. 1679.

[474] Under the tentative plan of February 3, 1929, Mr. Jonas would have received 745,000 shares of the stock of the combined company. On the other hand, Goldman, Sachs & Co. would hold, after the declaration of the 100% stock dividend on the existing shares of the stock of The Goldman Sachs Trading Corporation, only approximately 200,000 shares of the stock of that company (id., at 16296–7).

[475] Id., Commission's Exhibit No. 1679.

[476] Waddill Catchings, Arthur Sachs, Walter E. Sachs, Henry S. Bowers, Sidney J. Weinberg, and Howard J. Sachs (ibid.).

[477] Ibid.

shares.[479] As has been stated, Mr. Jonas and his immediate associates held only approximately 45% of the outstanding stock of Financial and Industrial Securities Corporation.[480]

Furthermore, indirectly at least, the consent of a majority of the stockholders of The Goldman Sachs Trading Corporation to the purchase of all of the assets of Financial and Industrial Securities Corporation would have to be obtained. The then authorized and unissued stock of The Goldman Sachs Trading Corporation totaled 1,375,000 shares.[481] However, under the tentative plan to which Mr. Catchings and Mr. Jonas had agreed, The Goldman Sachs Trading Corporation would be required to issue an additional 3,375,000 shares of its own stock—1,125,000 shares as a 100% stock dividend in its existing shares and 2,250,000 shares in payment for the assets of Financial and Industrial Securities Corporation. In order to fulfill its part of the plan, therefore, the authorized capital stock of The Goldman Sachs Trading Corporation would have to be increased. Under the corporation law of Delaware, this could not be done except by the affirmative vote of the holders of a majority of the corporation's shares. As has been stated, the firm of Goldman, Sachs & Co. then held 100,000 shares of The Goldman Sachs Trading Corporation or slightly less than 10% of the outstanding 1,125,000 shares of the company's stock.

Although the acquisition by The Goldman Sachs Trading Corporation of the assets of Financial and Industrial Securities Corporation would be advantageous to the firm of Goldman, Sachs & Co. by bringing under its dominion a controlling interest in a bank and three

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[478] In a letter dated February 18, 1929, to the stockholders of Financial and Industrial Securities Corporation, Mr. Jones stated (id., Commission's Exhibit No. 1687):

> A great many other stockholders have had this same viewpoint, and have urged that the only weakness in F. & I. was that its operation so largely depended upon a small number of individuals. Two of my associates have broken down under the strain. A third is now ill, and I myself have not had a day's vacation in two and a half years. It is not prudent to trust new associates with large responsibilities until they have been tried. Under these circumstances it seemed easier to combine with some existing organization of standing and tried and trusted ability and success.

In the same letter, Mr. Jonas advanced as another reason for the combination of Financial and Industrial Securities Corporation with The Goldman Sachs Trading Corporation the fact that "we [the management of Financial and Industrial Securities Corporation] believed also that The Goldman Sachs organization could materially aid the growth and profits of the Manufacturers Trust Company and the National Liberty group of Insurance Companies, and that this in turn would likewise result in direct benefit to the stockholders of the investment company owning large blocks of these securities" (ibid.). However, The Goldman Sachs Trading Corporation by January 1931, within two years after it had acquired the assets of Financial and Industrial Securities Corporation, had sold at tremendous losses the bulk of the shares of the Manufacturers Trust Company and the National Liberty group of insurance companies which had been included in the assets of Financial and Industrial Securities Corporation. See infra, pp. 1560–1.

[479] Although the Maryland Corporation law in general provides that a sale of all the assets of a company must be approved by the holders of two-thirds of its shares [Maryland Code Ann. (Flack 1935), Art. 23, § 36], it permits a corporation to provide in its certificate of incorporation for the approval of a sale of the corporate assets by the holders of only a majority of the shares (id., § 23). The certificate of incorporation of Financial and Industrial Securities Corporation contained such a provision (op. cit. supra, note 436, Commission's Exhibit No. 2096).

[480] Op. cit. supra, note 438, at 16281–2.

[481] The authorized capital stock of the company consisted of 2,500,000 shares of which it had already issued 1,125,000 shares. See supra, pp. 1524–5.

insurance companies, all of which were "big purchasers" of securities from investment bankers,[482] conceivably the other stockholders of The Goldman Sachs Trading Corporation might have objections to the amalgamation of the two companies. A substantial portion of the assets of the combined companies would be invested in controlling blocks of the stock of a bank and three insurance companies, a distinct departure from the semi-public statement that "the policy of The Goldman Sachs Trading Corporation would be to trade in securities."

The purchase of the assets of Financial and Industrial Securities Corporation, which as has been stated consisted primarily of controlling interests in a bank and three insurance companies, was also a distinct departure from a policy of investing in industrial securities of a type previously offered to the public by the firm of Goldman, Sachs & Co., a policy which, as Mr. Catchings testified,[483] had motivated that firm to form The Goldman Sachs Trading Corporation. Mr. Catchings conceded that the actual investment policy of The Goldman Sachs Trading Corporation was not "dominated" by the original concept of the investment policy which the company would pursue:[484]

Q. And you say that was the policy that dominated the investments of Goldman Sachs Trading Corporation, Mr. Catchings?

A. No; I do not. I didn't say that was the policy that dominated it. * * *

Moreover, the firm of Goldman, Sachs & Co., although experienced in the fields of investment banking and in the discounting of commercial paper,[485] had never managed or controlled banks and insurance companies. Mr. Catchings testified:[486]

Q. Had you ever been in the commercial banking business?

A. We had done a great deal of business in Goldman Sachs that was very similar to commercial banking.

Q. You don't say the business of owning 37 percent of the stock of a bank with 46 branches (Manufacturers Trust Company) is analogous to discounting commercial paper?

A. No; but knowledge of business conditions and risk and the possibility of lending money is something acquired in Goldman Sachs that is the same as in the commercial banking business.

Q. Had you ever been in the insurance business in your life?

A. Let me put it another way. With the exception of being in the iron business and a few other businesses I have described here, I have never actually been in any other kind of business. I have been combating the point of view that you are presenting to me for a great many years, and I have discovered that in the shoe business, in the iron business, and the department store business the executive problems of business are very much the same.

However, a sharp increase in the market value of the stock of The Goldman Sachs Trading Corporation as a result of the announcement of the plan to amalgamate the two companies would do much to over-

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[482] See notes 462 and 463, supra.

[483] Op. cit. supra, note 438, at 15888–94.

[484] Id., at 15894.

[485] Id., at 15886.

[486] Id., at 16091–2. In fact prior to the acquisition of the assets of Financial and Industrial Securities Corporation by The Goldman Sachs Trading Corporation, Mr. Catchings had never been a director of any bank (id., at 16527).

come any objections of the stockholders to the combination of the two companies. As will be described later, The Goldman Sachs Trading Corporation took steps to increase artificially the market value of its own stock before announcing a final plan for the combination of the two companies.

Similar objections to the plan might be urged by the stockholders of Financial and Industrial Securities Corporation. As has been stated, under the plan of February 3, 1929, the management of the combined companies was to be vested in Goldman, Sachs & Co., which had never been connected with the management of any investment company other than The Goldman Sachs Trading Corporation, then only two months old. Nor had the firm had any experience in the control and management of banks and insurance companies. On the other hand, Financial and Industrial Securities Corporation had been very successful during the three years that it had been managed by Mr. Jonas.[487] Clearly the stockholders of Financial and Industrial Securities Corporation might not agree to a shift of their assets to the untried management of Goldman, Sachs & Co. In fact, Mr. Jonas testified that he discussed this point with Mr. Catchings during the course of their negotiations:[488]

Q. And during the years that F. & I. had been in existence the management had been very successful, isn't that so, from the point of view of at least policies and unrealized appreciation on their securities?

A. That seemed to be the general opinion.

Q. And did you discuss with Mr. Catchings the problem of persuading the stockholders in F. & I. of turning in their stock of the trust that had had such a success for three years with a corporation which had just been organized one month on the basis of assets for assets and not market for market?

A. Well, I didn't discuss it from the viewpoint of persuading the stockholders, but I discussed it and Mr. Catchings felt that the prestige and standing and fifty years of existence of Goldman, Sachs & Company at least equaled or offset the good will that we had in the Financial and Industrial Securities Corporation.

Q. Of course, Mr. Waddill Catchings had not handled any investment company before that you know of?

A. No; I didn't know of any.

Q. You know that a substantial part of the business of Goldman, Sachs & Company was discount business and underwriting, but it didn't involve investment of substantial funds of money in either a diversified portfolio or in special situations. That wasn't their business, was it?

A. Well, I can't tell you specifically what their business was except by general reputation, Mr. Schenker, and that I heard Mr. Catchings refer to here.

In fact this objection to the combination of the two companies was apparently later urged publicly by some stockholders of Financial and Industrial Securities Corporation who according to Mr. Jonas "were rather vitriolic in their attack upon the deal and in writing to

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487 From December 9, 1925, to December 31, 1928, the assets of Financial and Industrial Securities Corporation had increased from $45,000,000 of contributed capital to upwards of $111,000,000 (op. cit. supra, note 436, at 19034) and it had earned between $55,000,000 and $60,000,000, of which approximately one-third had been paid out as dividends (id., at 19040–1).

488 Op. cit. supra, note 438, at 16273–4.

one or more of their newspapers about it." [489] In a letter dated February 18, 1929, written by Mr. Jonas to the stockholders of Financial and Industrial Securities Corporation recommending their approval of the sale of the company's assets to The Goldman Sachs Trading Corporation, it was stated: [490]

They [Goldman, Sachs & Company] further said that they could not concede that their stockholder's dollar was worth less than F. & I.'s, and that as against our three years of successful operation Goldman, Sachs & Company had had upwards of half a century of successful operation in every phase of investment banking which, taken together with the earnings and appreciation of The Goldman Sachs Trading Corporation of $6,000,000 in six weeks' time, justified the viewpoint that they would do quite as well, operating independently, as F. & I. would do.

However, there would be a far more serious objection upon the part of the stockholders of Financial and Industrial Securities Corporation to the tentative plan of combination of February 3, 1929. On February 2, 1929, the market value of the existing stock of The Goldman Sachs Trading Corporation was $136.50 per share. After the two-for-one split up of the stock contemplated by the plan it would presumably sell for $68.25 per share. On the other hand, the stock of Financial and Industrial Securities Corporation on the same date had a market value of $145 a share. In other words, under the plan of February 3, 1929, which contemplated a share per share exchange of securities, the stockholders of Financial and Industrial Securities Corporation would be asked to accept a stock having a market value of $68.25 per share for stock having a market value of $145 a share. Clearly, as Mr. Catchings testified,[491] "no fifteen or twenty thousand F. & I. stockholders are going to make a deal to exchange their stock marketwise for a stock that was selling at half the price it was selling for before they made the exchange. That is not in the realm of fact at all." Mr. Catchings further testified: [492]

Q. The F. & I. stockholders would never make that deal on the basis of asset value because the only thing he knew was that he had a stock with a higher market value than Goldman Sachs, and unless you could give him asset for asset and market for market, you could not persuade him to make the exchange; isn't that so?

A. Yes; I think it is not a matter of persuasion. It seems to me that in any exchange of stock the exchange when you get something else you are considering the market price of what you get.

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[489] Id., at 16289. Mr. Jonas further testified (id., at 16282, 16289):

Q. Was there any manifestation of dissension or disapproval or dissatisfaction with the terms of the merger among the stockholders, public expression?
A. Yes; out of about 15,000 stockholders, I think there were approximately 30 who took the position in opposition to the others.
Q. You mean at the meeting?
A. At the meeting or by communication to us or otherwise. I don't know what happened at the Goldman-Sachs end of it, but I am talking about the Financial and Industrial Securities end.

* * * * * * *

Q. Had the newspapers been carrying stories of people who were objecting to the merger?
A. I think they carried stories * * *.

[490] Id., Commission's Exhibit No. 1687.

[491] Id., at 16158.

[492] Id., at 16185–6.

Conceivably therefore, unless by the date of the stockholders' meetings called to ratify any plan for the combination of the two companies, the market value of The Goldman Sachs Trading Corporation stock was at a parity with the stock of Financial and Industrial Securities Corporation, it was at least doubtful that a majority of the stockholders of Financial and Industrial Securities Corporation would approve the plan. Moreover, even if the plan was approved by a majority of the stockholders of Financial and Industrial Securities Corporation, dissenting stockholders might exercise their right under the Maryland law to receive in cash the appraised "fair value" of their shares.[493]

Mr. Catchings conceded in his testimony[494] that on February 3, 1929, he had only a "business judgment" that the approval of the stockholders of Financial and Industrial Securities Corporation to the merger would be obtained:

Q. Now this involved, did it not, Mr. Catchings, the sale of all the assets including the good will of F. & I.; isn't that so?

A. Yes.

Q. And that required a certain percentage of the vote of the stockholders of F. & I.; isn't that so?

A. Yes.

Q. And the stockholders' meeting hadn't even been fixed on that day [February 3, 1929]; isn't that so? It ultimately was fixed for February 21, 1929?

A. Yes.

Q. So that up to the time that the stockholders approved this merger, you couldn't possibly tell whether it was going to be effective?

A. We could only have a business judgment as to whether it was going to be effective.

The disparity in market price of the stocks of the two companies had occupied a prominent place in the discussion between Mr. Catchings and Mr. Jonas. It will be recalled that in the early negotiations, Mr. Jonas had insisted on an exchange of the securities of the two companies on the basis of their market values. After Mr. Jonas had assented to a combination of the companies on an asset value basis, the difference in the market values of the securities of the company was again discussed. Mr. Jonas testified[495] that he believed that the loss in market value which the stockholders of Financial and Industrial Securities Corporation would suffer initially "would be more than made up in a comparatively short time":

Q. At the time that the exchange was suggested on the basis of assets for assets, of course there was this discrepancy in market price.

A. Yes.

Q. And what discussions did you have with Mr. Catchings with respect to this discrepancy in market price?

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[493] Md. Code Ann. (Flack 1935), Art. 23, §§ 36, 36½, which provide that dissenting stockholders on following the procedure specified in the law for obtaining an appraisal of their shares, are entitled to receive the "fair value" of such shares.

[494] Op. cit. supra, note 438, at 16247.

[495] Id., at 16275–7.

A. Well, the conversation was as I have indicated along the line of the basis of an agreement for exchange and that conversation was extended over several sessions.

Q. You misunderstand me. You had already decided on the basis of an exchange of asset for asset, but you still had the problem that you had to ask the F. & I. stockholders to give up a stock selling at a 100% premium for a stock that was selling at a 30% premium. You were going to ask him to make a sacrifice in market value.

A. On the face of it, apparently yes. Our feeling was that with the prestige at that time of Goldman, Sachs & Company and with their resources added to ours, and their management, that the stock would rapidly equalize itself and that whatever present discount the F. & I. stockholders might waive or have, would be more than made up in a comparatively short time. That was our feeling and the feelings of those around me.

Q. But the fact is that at that time you were asking him to give up a premium value there of 70 points, isn't that so?

* * * * * * *

A. We were asking them to give up the difference between the market value and the book value and the Goldman Sachs market value and book value.

Q. And wasn't there any talk at that time, Mr. Jonas, that that might be a serious obstacle in the effecting of the merger between F. & I. and Goldman Sachs because a fellow knew he had the 70 points difference. What you were holding out to him was a hope that not only would he recoup that 70 but would get more; isn't that so?

* * * * * * *

A. I said we took the position we were more interested in the stockholder who was going to be a permanent investor in the * * * combined companies than we were in the one, the stockholder trading in and out of the stock, or simply speculating in it, and we felt that for a long time investor the markets would not only equalize themselves but we believed sincerely they would have a great advantage in the combination.

Mr. Catchings testified [496] as follows as to his discussion with Mr. Jonas with respect to the disparity in the market price of the stocks of their two companies:

Q. * * * Was there any discussion as to what the effect on the market would be?

A. There were discussions with him at the time, yes.

Q. Do you remember what those discussions were?

A. It is possible now to remember them only vaguely, of course, but they were to the effect that The Goldman Sachs Trading Corporation stock after the exchange would sell on a parity with the price theretofore existing for Financial and Industrial stock.

Q. You were convinced of that fact?

A. I don't say one was convinced of it but it was our expectation that that would be the fact.

Mr. Catchings' "expectation" that the stocks of The Goldman Sachs Trading Corporation would eventually sell in the market at a price equivalent to that of the stock of Financial and Industrial Securities Corporation was based on what he characterized as the "wildest kind of opinion" that by the mere force of the agreement of the two

[496] Id., at 16329–30.

companies to combine it was "inevitable" that the market price of the stock of The Goldman Sachs Trading Corporation would reach its "natural level"; [497] that is, a price equivalent to the market value of the stock of Financial and Industrial Securities Corporation. Mr. Catchings testified: [498]

Q. Is this a correct statement? Was the deal between you and Mr. Jonas, each representing your corporation, that the exchange of stock would be on the basis of equal asset values for equal asset value as between Goldman Sachs Trading Corporation and F. & I.?

A. That is correct.

Q. At the time you made that deal, Goldman Sachs Trading Corporation was selling on the market at about 30 percent above its asset value?

A. That is correct.

Q. And F. & I. stock was selling at about 100 percent above asset value?

A. That is right; at about twice its asset value, approximately.[499]

Q. If then the deal was finally to be consummated, with the approval of the stockholders of F. & I. who exchanged the assets of F. & I. for Goldman Sachs Trading stock on the basis of equal asset value for equal asset value, or equal market value for equal market value, the parity of the two stocks on the basis of the trade would have been at a price of approximately 218 to 220 per share [500] for Goldman Sachs Trading stock?

A. That is correct.

Q. If the deal was to be consummated by an actual merger of the two corporations or the sale of F. & I. assets to The Goldman Sachs Trading Corporation on that basis it was inevitable, was it, that these stocks would come together at some market price?

A. That is correct, because there was going to be one stock only out of the deal, and that was going to be The Goldman Sachs Trading Corporation so that the F. & I. stockholders would only have The Goldman Sachs Trading Corporation as representing the market value, whatever it might be.

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[497] Id., at 16130–2.

[498] Id., at 16159–60.

[499] As at February 3, 1929, the market value of the stock of The Goldman Sachs Trading Corporation was $136½ a share; its asset value was $108 per share. The market value of the stock of Financial and Industrial Securities Corporation on the same date was $145 a share and its asset value was approximately $75 a share. See supra, p. 1534.

[500] This figure represented the market value which the existing 1,125,000 shares of The Goldman Sachs Trading Corporation stock, before giving effect to the 100% stock dividend to be declared on such stock, would have to attain in order to achieve a parity with the market value of the Financial and Industrial Securities Corporation stock under the final plan of combination decided upon by Mr. Catchings and Mr. Jonas. This final plan required the issuance of 2,250,000 shares of The Goldman Sachs Trading Corporation stock for the outstanding 1,700,000 shares of the stock of Financial and Industrial Securities Corporation. In other words, under the final plan 1–11/34 shares of The Goldman Sachs Trading Corporation stock were to be issued for each share of the stock of Financial and Industrial Securities Corporation. Since the market value of Financial and Industrial Securities Corporation stock was $145 a share, the stock of The Goldman Sachs Trading Corporation after the 100% split-up would have to sell at $110 a share if the stockholders of Financial and Industrial Securities Corporation were to receive shares of stock in the combined company having a market value equivalent to the market value of their own stock. However, under the tentative plan of February 3, 1929, which contemplated a share-for-share exchange of stock of the two companies, after a 100% split-up of the stock of The Goldman Sachs Trading Corporation, the existing 1,125,000 shares of the stock of The Goldman Sachs Trading Corporation would have had to reach a market value of approximately $290 a share if a parity with the market price of the stock of Financial and Industrial Securities Corporation was to be achieved. The reason for the abandonment of the tentative plan of combination of February 3, 1929 is described infra.

Q. Well, you tell us what is your reason for believing it is inevitable that the two stocks would come together by reason of making this deal at approximately $218 to $220 per share for The Goldman Sachs Trading Corporation stock.

A. My reason for believing it is that under the conditions existing at that time a price of twice the asset value for the investment company stock was a reasonable price and it had existed for a long time through the F. & I. stock. They have a very large number of stockholders and a recognition on the part of the F. & I. stockholders that they were willing to have the Goldman Sachs stock in exchange share for share for their stock was a recognition, in my opinion, that the Goldman Sachs stock was worth, under the conditions that prevailed at the time, marketwise, $215 to $220 a share.

Mr. Catchings further testified: [501]

A. * * * What I do say to you is that it would have gotten to the level at which it did get and where it stayed for a long time thereafter [502] even if we hadn't bought a share of stock.

Q. That is the wildest kind of conjecture.

A. It is absolutely the wildest kind of opinion.

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The very nature of the deal with F. & I. involved a recognition of the fact that The Goldman Sachs Trading Corporation stock should be selling around $220 to $230 a share because that is the basis on which the F. & I. stockholder agreed to take it.

However, as Mr. Catchings conceded, the 100% premium over its asset value at which the stock of Financial and Industrial Securities Corporation was selling in the open market was a reflection of the three years of successful operation of the company and constituted the public's estimate of the capability of Mr. Jonas' management. On the other hand, The Goldman Sachs Trading Corporation had been in existence only two months. It had no sustained record of management success. Presumably the public's appraisal of the management ability of Goldman, Sachs & Co. was reflected in the market value of the stock of Goldman, Sachs & Co. which on February 2, 1929, was selling at $136.50 a share, a figure only 30% in excess of its asset value. When questioned on this point, Mr. Catchings testified: [503]

Q. And F. & I. had made, as you recall it, $35,000,000 during the year 1928, exclusive of its unrealized appreciation on its securities.

A. I think that is a little larger than it was, but it was approximately that.

Q. Do you recall what their profit was in the year 1927, exclusive of its unrealized appreciation on securities?

A. My recollection is somewhere around nine to ten million dollars * * *.

Q. So that F. &. I. up to January 1, 1929, had had a successful record.

A. Yes.

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[501] Op. cit. supra, note 438, at 16132, 16137.

[502] The record indicates that the market price of the stock of The Goldman Sachs Trading Corporation was substantially influenced throughout the year 1929 by trading accounts operated in such stock by the investment company itself (see infra), by Goldman, Sachs & Co. and by W. C. Durant who conducted a trading account in the stock from March to July 1929, sharing at least some of his profits and losses with The Goldman Sachs Trading Corporation which had granted him options (which were in part exercised) to purchase its own treasury stocks. See infra and Ch. I of this part of the report, pp. 13–16.

[503] Op. cit. supra, note 438, at 16197–9.

Q. And of course that was reflected in its market premiums, isn't that so?

A. Yes.

Q. The fact is that the premium just means that. It means the value that you put upon the belief or faith that you have in the management to handle the money, isn't that so?

A. That is correct.

Q. Over a period of years, the public, basing its decision upon the performance of the Jonases in F. & I. placed a 100% premium upon their management, isn't that so?

A. Yes.

Q. Now, The Goldman Sachs Trading Corporation had only been in existence two months.

A. Yes.

Q. And you said it was natural that it would reach a premium of 100% too.

A. Yes. In the course of time it seemed to me that The Goldman Sachs Trading Corporation stock would sell on the same basis as other companies.

Q. You will pardon me, but that sounds a little conceited to me, because you had nothing to calculate what premium would be placed on your management of $100,000,000 of liquid funds. You determined that the premium that should be placed upon your future management of that fund should be 100 percent and then you started putting up the stock to where you thought the premium should be, isn't that so?

A. No.

Since most of the stockholders of Financial and Industrial Securities Corporation were unaware, on February 3, 1929, of the negotiations for the combination of their company with The Goldman Sachs Trading Corporation, it is obvious that they could not have "recognized" any relationship between the market price of their stock and that of The Goldman Sachs Trading Corporation. Mr. Jonas and his associates, who together owned 45% of the stock of Financial and Industrial Securities Corporation, evidently did not "recognize" that as a mere result of their agreement to combine the two companies, the market price of the stock of The Goldman Sachs Trading Corporation would appreciate in value to a point where it would be on a parity with that of Financial and Industrial Securities Corporation. Mr. Jonas testified: [504]

Q. Did he [Mr. Catchings] tell you that he hoped The Goldman Sachs Trading Corporation would go to 220 where it would be on a parity with the F. & I. stock?

A. I don't recall.

Q. You had that anticipation or hope, or else I think you told us that you felt that through the combination of both companies that the stock would go to 220 based upon their 50 years of reputation.

A. I didn't mention its going to 220. I said I felt the stocks would adjust themselves to a mutual position. Whether one was up or one was down, I felt that sooner or later the Financial and Industrial Securities stockholders would get the advantage of the combination with Goldman Sachs.

Q. The only way they could get the advantage of that combination is that they would receive ultimately a market price more than they were giving up; isn't that so?

A. Yes.

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[504] Id., at 16287–8.

Q. And they were giving up 70 points in premium, isn't that so?

A. I didn't have in mind whether that would come in one week or thirty days or six months.

* * * * * * *

Q. Now, you say you knew, Mr. Jonas, that either the F. & I. would go down or the Goldman Sachs would go up. You weren't certain that the Goldman Sachs would go up to the level of the F. & I. The possibility was that people might make a blocked arbitrage and bring the F. & I. down to the level of Goldman Sachs.

A. I didn't know what might happen in the immediate time at that period, but I felt very confident that the ultimate result would be a desirable result. That was my best judgment at that period.

Despite Mr. Catchings' belief in the "inevitability" of a rise in the market value of the stock of The Goldman Sachs Trading Corporation to a point equivalent to the market value of the stock of Financial and Industrial Securities Corporation, it is significant that no immediate announcement of the prospective combination of the two companies was made to their stockholders. Instead, as part of the February 3, 1929, plan, an account [505] was formed to trade in the stock of both The Goldman Sachs Trading Corporation and Financial and Industrial Securities Corporation. The participants in this account were The Goldman Sachs Trading Corporation and Delmar Capital Corporation, one of Mr. Jonas' "office corporations" [506] which he controlled and of which he was the largest stockholder.[507] The agreement [508] creating the account recited that "In connection with the proposed acquisition by The Goldman Sachs Trading Corporation of the assets of Financial and Industrial Securities Corporation, this is to confirm our understanding that we both deem it expedient to arbitrage in the stock of these two companies * * *." The account was to operate for 30 days unless sooner terminated by the purchase by The Goldman Sachs Trading Corporation of all of the assets of Financial and Industrial Securities Corporation. The agreement of the parties further provided that if the purchase of the assets of Financial and Industrial Securities Corporation by The Goldman Sachs Trading Corporation occurred within the 30-day period of the duration of the account, the entire profit and loss in the account was to be borne by The Goldman Sachs Trading Corporation, which also was to receive all of the stock accumulated by the account.[509] However, if the purchase by The Goldman Sachs Trading Corporation of the assets of Financial and Industrial Securities Corporation was not consummated within the 30-day period of the duration of the account, then Delmar Capital Corporation was to have a one-half interest in the account and was to share equally in its profits and losses.[510]

The Goldman Sachs Trading Corporation was to be the manager of the account and was "in its uncontrolled discretion" to have full power to buy, sell, and generally trade in the stock of the two companies.[511]

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[505] The terms of this account were put in writing on February 4, 1929 (id., Commission's Exhibit No. 1677).

[506] Id., at 16126.

[507] Id., at 16264.

[508] Id., Commission's Exhibit No. 1677.

[509] Id., at 16135.

[510] Ibid.

[511] Id., Commission's Exhibit No. 1677.

As will be seen hereafter, the purchase of all the assets of Financial and Industrial Securities Corporation by The Goldman Sachs Trading Corporation occurred within the 30-day period of the duration of the account, so that under its terms The Goldman Sachs Trading Corporation became the sole owner of the stock accumulated by the account.

Mr. Jonas testified that he, through his controlled company, Delmar Capital Corporation, agreed to participate in this account because Mr. Catchings thought it was desirable to do so [512] "from the viewpoint of buying and selling the stock." [513] Mr. Jonas also conceded in his testimony that this account, which, as will be described later, concentrated its activities in purchases of the stock of The Goldman Sachs Trading Corporation on the market, was not in fact an "arbitrage" account although it was so labeled in the agreement creating the account. Mr. Jonas testified: [514]

Q. Now, Delmar Capital Corporation did enter into the joint account with The Goldman Sachs Trading Corporation to trade in the stock of The Goldman Sachs Trading Corporation. What did you conceive the purpose of the account to be, Mr. Jonas?

A. To arbitrage in the stock or to buy and sell the stock, in the discretion of The Goldman Sachs Trading Corporation, who were the managers of the account.

Q. Did it turn out to be an arbitrage account?

A. I don't know how much arbitraging there was done in the stock.

Q. Arbitrage means you buy one and sell the other, but this trading was just with the Goldman Sachs Trading Corporation common stock?

A. I understand that a substantial amount of The Goldman Sachs Trading Corporation stock was purchased, and a part of it resold. That apparently was the main thing for which the account was used.

Q. That is not arbitrage, that is just trading in the stock.

A. Yes.

Mr. Catchings testified that the account was formed "for the purpose of being active in the market during the time until the stock [of The Goldman Sachs Trading Corporation] reached its natural level," [515] that is, until the stock of The Goldman Sachs Trading Corporation attained a market value on a parity with that of Financial and Industrial Securities Corporation. Mr. Catchings contended that since the stock of The Goldman Sachs Trading Corporation would "inevitably" appreciate in market value to a parity with that of the Financial and Industrial Securities Corporation, the trading account which had been formed on February 4, 1929, would enable The Goldman Sachs Trading Corporation to derive the profit which otherwise would be made by "speculators" who would have bought the stock in connection with the "advance" [516] which "would have taken place in connection with the consummation of the merger deal." [517]

However, on February 4, 1929, when the trading account formed by Delmar Capital Corporation and The Goldman Sachs Trading Cor-

[512] Ibid.
[513] Id., at 16286–7.
[514] Id., at 16277.
[515] Id., at 16131.
[516] Id., at 16161.
[517] Ibid.

poration commenced to purchase substantial blocks of The Goldman Sachs Trading Corporation stock in the open market, the general public was unaware of the precise details of the plan to combine the companies. In fact, Mr. Catchings and Mr. Jonas, themselves, although they were aware that the combination would take place on the basis of the asset values of the stocks of the two companies, "didn't know at that time what machinery was going to be adopted for carrying it out." [518]

On February 4, 1929, the general public was only aware of a rumor that the two companies were to combine. Whether the basis of combination was to be the asset value or the market value of the respective stocks was unknown.[519] Nor were the "speculators" aware of the value of the assets of The Goldman Sachs Trading Corporation which had as yet published no reports. The value of the assets of Financial and Industrial Securities Corporation on February 4, 1929, was also not disclosed to the public.[520] More important, the public was not aware of the terms of the exchange of shares. They were unaware of the fact that it was the then intention of the parties to increase the existing The Goldman Sachs Trading Corporation stock to 2,250,000 shares by means of a two-for-one split-up of the stock and to issue an additional 2,250,000 shares to the stockholders of Financial and Industrial Securities Corporation. Nor was the public aware of the fact that it was contemplated that the outstanding 1,700,000 shares of Financial and Industrial Securities Corporation were to be increased to 2,250,000 by an offering of 550,000 shares of such stock to the company's existing stockholders.[521]

Certainly without a knowledge of these facts, it would be difficult for "speculators" to trade in the stock of The Goldman Sachs Trading Corporation or of Financial and Industrial Securities Corporation.[522] Moreover, the speculators may have shared Mr. Jonas' opinion that it was possible that the market price of the Financial and Industrial Securities Corporation stock would decline to the level of the stock of The Goldman Sachs Trading Corporation as a result of the announcement of the merger.

Not until February 11, 1929, was a final plan for a combination of the two companies, which differed radically from the original plan of February 3, 1929, announced. On that date, however, as a result primarily of previous substantial market purchases of the stock of The Goldman Sachs Trading Corporation by the trading account formed on February 4, 1929, the market price of The Goldman Sachs Trading Corporation's existing stock had reached a parity with that of Finan-

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[518] Id., at 16189.

[519] Id., at 16177–84.

[520] The annual report of Financial and Industrial Securities Corporation for the year ending December 31, 1928, was not completed by the company's auditors until February 28, 1929 (op. cit. supra, note 436, Commission's Exhibit No. 3006).

[521] Op. cit. supra, note 438, at 16188.

[522] On February 7, 1929, there appeared in *The New York Times*, p. 36, a report of the impending combination of the two companies which was derived from an interview with Mr. Catchings. The plan of combination as described in the report was substantially that upon which Mr. Jonas and Mr. Catchings had tentatively agreed on February 3, 1929. However, the report added: "The terms on which the Financial and Industrial will increase its capital have not yet been announced and until this is done it will not be known exactly the basis on which the shares of the two companies will be exchanged for stock of the new company."

cial and Industrial Securities Corporation, on the basis of the final plan for the combination of the two companies.

On February 2, 1929 (Saturday), the stock of The Goldman Sachs Trading Corporation closed on the New York Curb Exchange at $136.50 a share.[523] The volume of trading on that day was 14,800 shares. On the following Monday, February 4, 1929, The Goldman Sachs Trading Corporation, as the manager of the joint account between itself and Delmar Capital Corporation, commenced market operations in its own stock. On that day, as a result of a "leak," [524] from an undisclosed source, of the impending combination of the two companies, "there was a tremendous hullabaloo" [525] and the market in the stock of The Goldman Sachs Trading Corporation did not open until 11 o'clock in the morning. At that time, the specialist in the stock had bids of $175 a share for the stock,[526] a price approximately 40 points higher than the previous closing price for the stock. Despite the substantial advance in the price of the stock and the opportunity to make a 40-point profit, The Goldman Sachs Trading Corporation, although requested to do so by the specialist in the stock, refused to supply stock to meet the bids on his book.[527] Instead, The Goldman Sachs Trading Corporation put in buying orders for its own stock and at the end of the day's trading had purchased 53,200 shares of its own stock or 54% of the total of 98,600 shares traded on the New York Curb Exchange for the day.[528] Not a share of its own stock was sold by The Goldman Sachs Trading Corporation in the market.[529] The price of the stock closed at $178 a share.[530]

On February 5, 1929, The Goldman Sachs Trading Corporation as manager of the joint account with Delmar Capital Corporation purchased 42,300 shares of its own stock on the New York Curb Exchange, or 76% of the total of 56,500 shares of such stock traded on the New York Curb Exchange for the day. Again no shares were sold by The Goldman Sachs Trading Corporation. The closing market price for the stock on February 5, 1929, was $179⅝. On February 6, The Goldman Sachs Trading Corporation in its capacity as manager of the joint account purchased 9,100 shares of its own stock on the New York Curb Exchange, or the equivalent of 33% of the total of 28,000 shares traded on the New York Curb Exchange for the day. The Goldman Sachs Trading Corporation again did not sell a share of its stock on the New York

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[523] Op. cit. supra, note 438, at 16137.

[524] Id., at 16128.

[525] Ibid.

[526] Id., at 16137.

[527] Id., at 16136.

[528] Id., at 16140–1.

[529] Ibid.

[530] Ibid. These and subsequent purchases of its own stock were made by The Goldman Sachs Trading Corporation notwithstanding a resolution of its directors on December 14, 1928, that "the officers of this corporation are instructed that in exercising the corporate power of dealing in the stock of the corporation they be governed by the principle of making such transactions only when the purchases or sales at the prices at which made are, in their opinion, for the best interest of the corporation and not merely for the purposes of affecting the price of the stock in the market." (Derived from supplementary information supplied the Commission for The Goldman Sachs Trading Corporation [minutes of the meeting of the Board of Directors of The Goldman Sachs Trading Corporation, December 14, 1928].)

Curb Exchange. The closing price of the stock for the day was \$187⅞. On February 7, 1929, The Goldman Sachs Trading Corporation purchased 69,800 shares of its own stock on the New York Curb Exchange or 77% of the total of 89,500 shares of such stock traded on the exchange that day. On the same day, The Goldman Sachs Trading Corporation sold 4,500 shares of its own stock on the market. The closing market price of the stock of The Goldman Sachs Trading Corporation on February 7, 1929, was \$221 a share. To sum up, from February 4, 1929, to February 7, 1929, inclusive, The Goldman Sachs Trading Corporation purchased on the New York Curb Exchange 174,400 shares of its own stock at a total cost of approximately \$33,325,000 and sold only 4,500 shares for total proceeds of approximately \$975,000. Its purchases over the 4-day period constituted 64% of the total purchases of the stock on the New York Curb Exchange.[531]

The price of the stock rose from \$136.50 a share on February 2, 1929, a price 30% in excess of its asset value,[532] to \$221 a share on February 7, 1929, a price roughly equivalent to twice its asset value.[533]

The purchasing activities of the joint account in the stock of The Goldman Sachs Trading Corporation from February 4 to February 7, 1929, reflected all of the techniques of a typical pool or trading account which has for its purpose the manipulation of the market price of a security to a point higher than its previously existing level. The account confined its activities primarily to buying; its predominant purchasing resulted in a sharp increase in the volume of trading in the stock,[534] a factor which alone would attract the public's attention to the stock. Furthermore, the activities of the account included purchases of the stock at the opening of each day's trading at higher levels than the previous day's closing price for the stock,[535] and "run

[531] Op. cit. supra, note 438, at 16141–3.

[532] Id., at 16157.

[533] Id., at 16144.

[534] The daily volume of trading in the stock of The Goldman Sachs Trading Corporation on the New York Curb Exchange for the four days prior to February 4, 1929, and for the period February 4 to February 7, 1929, was as follows:

Date	Volume of trading on New York Curb Exchange
	Shares
Jan. 30, 1929	9,800
Jan. 31, 1929	16,200
Feb. 1, 1929	17,400
Feb. 2, 1929	14,800
Feb. 4, 1929	98,600
Feb. 5, 1929	56,500
Feb. 6, 1929	28,000
Feb. 7, 1929	89,500

[535] On February 5, 1929, the market in the stock of The Goldman Sachs Trading Corporation opened at \$178, the previous day's closing prices and The Goldman Sachs Trading Corporation bought 41,300 shares at this price (op. cit. supra, note 438, at 16149). On February 6, 1929, the market opened at \$180½, ⅞ up from the previous day's closing prices, and The Goldman Sachs Trading Corporation bought 500 shares at this price (id., at 16150). On February 7, the market opened at \$195, ⅞ up from the previous day's closing, and the corporation bought 14,700 shares at this price (id., at 16152).

ups" of the stock to new highs at the close of each day's trading.[536] In other words, the account itself established the market price of the stock on the New York Curb Exchange at the opening and closing of each day's trading in the stock.

Sidney J. Weinberg, a partner in Goldman, Sachs & Co. and one of the directors of The Goldman Sachs Trading Corporation, when examined on market activities of this character, testified: [537]

Q. Let me ask you an elementary question, Mr. Weinberg. If you keep buying on the Exchange continuously, without any counter-selling on the Exchange, it is almost inevitable that the state of the market must be improved?

A. Well, buying actually improves the market; we know that.

Q. It is an almost foregone conclusion that the price will go up; isn't that so?

A. It depends, I say, upon the security, Mr. Schenker, and the way you do it.

Q. Well, now, just take the ordinary case where a fellow goes in and buys 50 to 60 percent of all of the stock offered on the Exchange; would that put the price up?

A. I will take your word that if a man goes in and buys it that way. It depends upon how you do it, but it has a tendency to put it up.

* * * * * * *

Q. Now, in any pool, Mr. Weinberg, there are certain well known techniques. If you want to create the impression that there is a public demand for the stock, the way to do it, is it not, is to have what we call "run-ups," to have the stock come up at say 30, 30½ and 30¾ and 31.

A. We [Goldman, Sachs & Co.] didn't practice it.

Q. I am not saying that you did, but I am trying to get the indicia of a pool.

A. Yes; there are many ways to do it, I suppose; yes.

Q. Well, when a fellow sees it coming on, the stock 30, 30½, 30½, and 30¾, he thinks the public is feverish for it?

A. Yes; that might be so.

Q. And another thing to do is to try to offer the stock at a little higher price than the close of the night before; isn't that so?

A. Yes; I suppose so.

Q. And then another favorite device (we hope used to be and is not now)——

A. "Is not now" is right.

Q. We hope—is to make a new high at the close; isn't that so?

A. Well, I suppose those were practices; yes.

Q. And then, of course, another factor in any manipulative account is mere force of volume; isn't that so?

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[536] On February 4, 1929, the stock of The Goldman Sachs Trading Corporation closed at $178 a share as the result of the purchase by The Goldman Sachs Trading Corporation of 19,300 shares of the stock at the end of the day's trading (id., at 16149). On February 5, 1929, The Goldman Sachs Trading Corporation's stock closed at $179⅝. The last trades in the stock for the day, all of which were purchases by The Goldman Sachs Trading Corporation, were 200 shares at $179⅛; 200 shares at $179¼; 200 shares at $179⅜; 200 shares at $179½; and 100 shares at $179⅝, the closing price. The stock thus closed a point and five-eighths above the previous day's closing price (ibid.). On February 6, 1929, the last four trades in the stock represented purchases by The Goldman Sachs Trading Corporation at progressively higher prices to create a price of $187⅞, a new high level for the stock. The purchases made by The Goldman Sachs Trading Corporation at the close of the market on this day were 300 shares at $185; 100 shares at $187½; 100 shares at $187¾; and 100 shares at $187⅞ (id., at 16150). On February 7, 1929, the closing market price of the stock was $211, which was established by a purchase by The Goldman Sachs Trading Corporation of 1,000 shares at that price at the end of the day (id., at 16152).

[537] Public Examination, Central States Electric Corporation, at 13457–8 and 13514–16.

A. I am taking your assumptions, that they are all correct; yes. You seem to know more about it than I do.

Q. Are you serious about that?

A. I am serious about that.

Q. How long have you been in Wall Street?

A. Thirty years.

Q. You mean to say it is the first time that you have heard that?

A. No; I have heard of it before.

Q. And you have seen it, too, haven't you?

A. I have heard of it and I probably have seen it, too.

Q. And even if the price is stable, if there is a large volume, that will excite interest in the stock; isn't that so?

A. Probably; yes.

Q. The mere impact of the volume of trading attracts attention to the stock; isn't that so?

A. I suppose so.

Mr. Catchings, however, denied that the account was a manipulative one, apparently because, in his "wild opinion," irrespective of the activities of the trading account the market price of the stock of The Goldman Sachs Trading Corporation would have risen to $220 a share by the mere force of the agreement of the two companies to combine. Mr. Catchings, however, did not deny that the operations of the trading account may have accelerated the rise of the market price of the stock of The Goldman Sachs Trading Corporation from $136½ per share to $221 a share between February 4 and February 7, 1929, although he denied that that was the purpose of the account. He testified: [538]

A. * * * I say the facts as I formed the account and as I handled it and directed its activities, I tell you with great positiveness, that the account was not formed for the purpose of putting up stock and that it was not formed for the sake of manipulating the market but was formed for the purpose of being active in the market during the time until the stock reached its natural level.

Q. That is assuming that it was going to reach a level?

A. Stocks always reach a level; they are always on a level.

Q. And do you deny that your trading in that stock helped to place the stock at what its level was?

A. You and I have gone over this ground before and I say to you now the same thing I said to you then that I think the stock would have gone to precisely the same point it did go whether we bought the stock or didn't.

Q. That is why I was meticulously careful the first day to have you repeat the statement, "Let's not say what would have happened had something else happened."

A. That is correct.

Q. And you say that regardless of the trading that was done in that stock by The Goldman Sachs Trading Corporation, that stock would have gone to $220, which it ultimately reached on February 7, which was four days after the news came out.

A. I don't say it would have gone there on February 7th.

Q. But you do deny that with your trading you put it there on February 7th?

A. I don't know whether our trading put it there or whether it didn't. I say it got there on February 7th, that is a certainty, and I am not saying to you

[538] Op. cit. supra, note 438, at 16131–2.

that it would or would not have gotten there if we hadn't bought stock during these few days, but what I do say to you is that it would have gotten to the level at which it did get where it stayed for a long time thereafter,[539] even if we hadn't bought a share of stock.

Q. That is the wildest kind of conjecture.

A. It is absolutely the wildest kind of opinion.

Mr. Catchings further testified:[540]

A. * * * The very nature of the deal with F. & I. involved a recognition of the fact that The Goldman Sachs Trading Corporation stock would be selling around $220 to $230 a share because that is the basis on which the F. & I. stockholders agreed to take it.

Q. When you say involved a recognition, that is you and Mr. Jonas sat down and said, "this stock should sell at $220" and you were going to put it there?

A. Most emphatically no; you can argue that all you want, I am trying to tell you what the facts are.

Q. You told me that the whole basis of the deal involved a recognition that the Goldman Sachs stock should be selling at $220 because that was the basis upon which the exchange was made, so you and Jonas sat down and said "Goldman Sachs should be selling at $220."

A. No, sir.

Q. It wasn't selling at $220 before that time?

A. No; but the F. & I. stock was selling at or above that price * * *.

Q. To my mind that has absolutely nothing to do with what transactions you consummated on the New York Curb Exchange because what was your subjective intent with respect to what the price should be or was has nothing to do with what the effect of your purchases was on the market.

A. My subjective intent hasn't anything to do with it. What was actually the situation was that a deal was made between two great groups where one group was willing to take The Goldman Sachs Trading Corporation stock as of the market parity with their own and that was the whole point of the thing. The deal was made on that basis * * *.

Q. I am not denying that, but I am saying that the deal having been made on that basis, you went out deliberately with your purchases to get it at that parity.

A. No; the whole point is that the stock went there, we didn't have to put it there; it would have gone there itself.

Mr. Jonas, on the other hand, when interrogated as to the effect on the market price of the stock of The Goldman Sachs Trading Corporation created by the purchasing activities of the joint account, testified:[541]

Q. Did you know that on * * * February 4, when the news of the merger leaked out, that they [The Goldman Sachs Trading Corporation on behalf of the joint account] purchased a substantial block of stock, 53,200 shares for $9,376,-250, and didn't sell a single share upon the exchange? Did they tell you that was their first day's business, Mr. Jonas?

A. I don't recall having been told.

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[539] See note 502, supra.

[540] Op. cit. supra, note 438, at 16137–9.

[541] Id., at 16278.

Q. Do you also take the position that the purchase of 53,200 shares on that date which constituted 55% of the volume of trading on the New York Curb Exchange, had no effect on moving the price of that stock up, and that it would have gone up with that rapidity whether you did that buying or not?

A. I don't know, it would be a mere guess on my part. I assume that buying a large block would affect the market. I thought the market would adjust itself regardless of this account.

In contrast to the sharp rise in the market price of the stock of The Goldman Sachs Trading Corporation between February 4 and February 7, 1929, the stock of Financial and Industrial Securities Corporation, which was traded only over the counter, remained fairly stable at a price between $136 and $150 a share between February 4, 1929, and February 21, 1929, the date that a majority of the stockholders of Financial and Industrial Securities Corporation approved the sale of its assets to The Goldman Sachs Trading Corporation.[542] However, the stability of the market price of the stock of Financial and Industrial Securities Corporation may have been the result of the purchase by The Goldman Sachs Trading Corporation between February 6 and February 21, 1929, of 70,318 shares of the stock of Financial and Industrial Securities Corporation at prices between $135¾ to $146¼ a share and sales by The Goldman Sachs Trading Corporation over the same period of 26,257 shares of the stock of Financial and Industrial Securities Corporation at prices between $127 and $152 a share.[543]

As has been stated, the result of the purchasing activities of the joint account was to establish on February 7, 1929, a market value of $221 a share for each of the existing 1,125,000 shares of the stock of The Goldman Sachs Trading Corporation. A 100% stock dividend on the stock at this time would create 2,250,000 shares of The Goldman Sachs Trading Corporation stock which presumably would have a market value of $110.50 a share. And if an additional 2,250,000 shares of new stock of The Goldman Sachs Trading Corporation were issued for the 1,700,000 shares of the stock of Financial and Industrial Securities Corporation, each existing share of Financial and Industrial Securities Corporation stock would be exchangeable for 1 11/34 shares of the stock of The Goldman Sachs Trading Corporation. Since the market value of the stock of Financial and Industrial Securities Corporation was then approximately $145 a share, 1 11/34 shares of The Goldman Sachs Trading Corporation, with a market value of $110.50 per share, would have a market value approximately equivalent to the market value of the stock of Financial and Industrial Securities Corporation. In other words, the market price of $221 per share for the existing shares of stock of The Goldman Sachs Trading Corporation created by the purchasing activities of the joint account was on a parity with the market price of the stock of Financial and Industrial Securities Corporation, on the basis of an exchange of 2,250,000 shares of new stock of The Goldman Sachs Trading Corporation for the 1,700,000 outstanding shares of the stock of Financial and Industrial Securities Corporation.

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[542] On February 4, 5, and 6, 1929, the stock of Financial and Industrial Securities Corporation was quoted over the counter at $150 a share. However, by February 19, 1929, the price had dropped to $144 a share.

[543] Op. cit. supra, note 438, Commission's Exhibit No. 1685. In addition to the purchases and sales of Financial and Industrial Securities Corporation stock referred to in

Apparently because of this fact, Mr. Catchings and Mr. Jonas determined on February 7, 1929, to abandon the tentative plan of February 3, 1929, in favor of the exchange ratio for the shares of the company which has just been described.[544]

Under this revised plan, the combined company would have outstanding 4,500,000 shares of stock equally distributed among the former stockholders of the individual companies, and the exchanging Financial and Industrial Securities Corporation stockholders would obtain securities in the new company having a market value equivalent to the market value of their existing shares.

However, as has been stated, the value of the assets of The Goldman Sachs Trading Corporation had been fixed at $122,000,000 on February 3, 1929, and on the same date the value of the assets of Financial and Industrial Securities Corporation had been fixed at $111,000,000. Unless under the new plan the assets of the two companies were equalized in value, the exchange would result in a gain in asset value to the stockholders of Financial and Industrial Securities Corporation. Accordingly, on February 7, 1929, a readjustment of the value of the assets of the two companies was made. The market value of the assets of Financial and Industrial Securities Corporation was revised upwards to $117,500,000, and the original plan to have Financial and Industrial Securities Corporation increase its assets to $122,000,000 by selling to its stockholders 550,000 additional shares of its stock at $20 a share was abandoned. Instead, The Goldman Sachs Trading Corporation agreed to reduce the value of its existing assets from $122,000,000 to $117,500,000 by the payment of a cash dividend of $4,500,000 to its existing stockholders.[545] Thus the two companies would be combined on an equal asset value as well as on an equal market value basis.

Although on February 7, 1929, the assets of Financial and Industrial Securities Corporation were valued at $117,500,000, it will be recalled that on February 3, 1929, such assets were valued at $111,000,000. The $6,500,000 increase in the value of the assets of Financial and Industrial Securities Corporation in the 4-day period from February 4 to February 7 were attributed by Mr. Catchings [546] to a rise in the market value of the company's portfolio securities. How-

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the text, The Goldman Sachs Trading Corporation between February 21 and March 12, 1929, purchased 12,696 shares of the stock of Financial and Industrial Securities Corporation and sold 375 shares of such stock. On March 12, 1929, The Goldman Sachs Trading Corporation had accumulated and held 56,352 shares of the stock of Financial and Industrial Securities Corporation at an average cost of $146.24 a share. These shares were, pursuant to the final plan for the combination of the two companies adopted on February 7, 1929 (see infra), converted into 74,623 shares of the new stock of The Goldman Sachs Trading Corporation on the basis of 1–11/34 shares of the stock of The Goldman Sachs Trading Corporation for each share of the stock of Financial and Industrial Securities Corporation and added to the other shares of its own stock which The Goldman Sachs Trading Corporation had accumulated as the result of its participation in the joint account with Delmar Capital Corporation (id., Commission's Exhibit No. 1685).

[544] The agreement of the parties to the new plan was expressed in written form on February 9, 1929 (id., Commission's Exhibit No. 1680).

[545] Ibid. This cash dividend was actually paid on March 15, 1929, but amounted to only $3,481,230 (id., at 15870 and Commission's Exhibit No. 1657), since no dividends were paid on the holdings of its own stock which The Goldman Sachs Trading Corporation had accumulated as the result of its market purchasing activities. The dividend was paid from "paid-in surplus" and therefore was in effect a return of the capital contributed by the stockholders to the enterprise (id., Commission's Exhibit No. 1657).

[546] Id., at 16202.

ever, $4,000,000 or two-thirds of the total appreciation in the assets of Financial and Industrial Securities Corporation in the 4-day period was the result of the increase in the market value of the 49,000 shares of the stock of The Goldman Sachs Trading Corporation in the portfolio of Financial and Industrial Securities Corporation from $136.50 to $221 a share, an increase which was solely the result of the trading activities in its own stock by The Goldman Sachs Trading Corporation as manager of its joint trading account with Delmar Capital Corporation. Despite the fact that the $4,000,000 appreciation in the stock of The Goldman Sachs Trading Corporation held by Financial and Industrial Securities Corporation had been the result of the market purchases by The Goldman Sachs Trading Corporation itself, Mr. Catchings denied that the value of the assets of Financial and Industrial Securities Corporation had been artificially "jacked up" by $4,000,000: [547]

Q. Substantially, Mr. Catchings, I think you will agree that the major portion of the portfolio of Financial and Industrial Securities Corporation was the Manufacturers Trust Company, the insurance companies, the Pick Barth picture, the Stern Brothers picture, and The Goldman Sachs Trading Corporation stock and cash, wasn't that so?

A. Yes.

Q. And the first agreement, February 6th, said "We will take these assets at $111,000,000," on February 9th they said, "We will take these assets at $117,-500,000." During this period the Manufacturers Trust stock had not moved up substantially, had it?

A. I don't recall, but I don't believe it had.

Q. The insurance stock had not moved up substantially, had they?

A. No.

Q. The Broadmoor stock had not moved up?

A. No.

Q. It had no market?

A. No.

Q. Stern Brothers had not moved up substantially?

A. No.

Q. Pick Barth had not moved up substantially?

A. No.

Q. Your [Financial and Industrial Securities Corporation] cash had not moved up?

A. No.

Q. So the only thing that could possibly have moved up was The Goldman Sachs Trading Corporation stock?

A. Yes.

Q. And that increase was $4,000,000, isn't that so, because the increase was approximately 85 points and you had 49,000 shares of The Goldman Sachs Trading Corporation stock there. And those $4,000,000 resulted from the fact that you jacked up the assets of F. & I. on the basis of the increase in price in The Goldman Sachs Trading Corporation stock, isn't that so?

A. Don't ask me to say jacked up——

Q. All right.

A. Let us get along without adjectives. If you want me to testify that the market prices of The Goldman Sachs Trading Corporation stock in the F. & I.

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[547] Id., at 16193-6

porfolio was increased by whatever the amount was, approximately $4,000,000. I will say yes.

Q. And that increase was during the period that The Goldman Sachs Trading Corporation purchased stock on the New York Curb Exchange on February 4th, purchased on February 5th, and purchased on February 6th, which had absolutely nothing to do with the rise in the price of The Goldman Sachs Trading Corporation stock, is that it?

A. I say that the nature of the agreement on February 3d was to recognize that as a proper market price for The Goldman Sachs Trading Corporation, but of course these activities had taken place in the meantime.

Q. So that you say on February 6th or on February 3d it was already agreed that The Goldman Sachs Trading Corporation stock in the portfolio of F. & I. would be taken at $221?

A. No; I say this, I don't think that the market activity of the stock during these days was of importance so much as the fact that by the very nature of the agreement the Goldman Sachs stock was taken as being worth, marketwise, twice its asset value.

Q. I am going to discuss that with you, but first let me get the facts. The fact is you say you did take it in originally at $221 on February 3d?

A. I say when you——

Q. On February 3d you did take in your Goldman Sachs Trading Corporation stock in computing the asset value of F. & I. at $221, did you?

A. All that was done on February 3d—you can't do everything in one minute—all that was done on February 3d was to reach an agreement that a plan would be worked out on the basis of the consolidation of the two companies on relative assets.

Q. But the more important thing is that the assets of both companies were fixed at that date at $111,000,000 for F. & I. and $122,000,000 for The Goldman Sachs Trading Corporation, isn't that so?

A. That is what is in the letter of February 6th.

Q. We find on February 9th there is computed for the purpose of this exchange an asset value to the portfolio of F. & I. of $117,500,000 which is $6,500,000 in excess of what was fixed in the 3d and it was during this period from the 4th to 7th that The Goldman Sachs Trading Corporation was doing this substantial buying on the New York Curb Exchange, isn't that so?

A. Yes.

As has been described, on February 7, 1929, the market price of the stock of The Goldman Sachs Trading Corporation had reached a parity with that of the stock of Financial and Industrial Securities Corporation on the basis of the plan for the combination of the two companies which was finally worked out by Mr. Catchings and Mr. Jonas on the same day.

On February 7, 1929, The Goldman Sachs Trading Corporation announced the declaration of a 100% stock dividend on its existing shares payable on February 25, 1929; and on February 11, 1929, the stockholders were, for the first time, fully informed of the final plan for the merging of the two companies.[548] On that day, both com-

[548] *The New York Times,* February 12, 1929, p. 41. Previously, on February 7, 1929, there had appeared in the same newspaper an announcement of the prospective combination of the two companies on the basis of the original plan of February 3, 1929 (*The New York Times,* February 7, 1929, p. 36).

panies addressed letters to their stockholders announcing meetings of such stockholders to be held on February 21, 1929, and soliciting proxies—in the case of the Financial and Industrial Securities Corporation stockholders for their approval of the sale of the company's assets to The Goldman Sachs Trading Corporation,[549] and, in the case of the stockholders of The Goldman Sachs Trading Corporation, for their approval of an increase in its authorized capital stock from 2,500,000 to 10,000,000 shares.[550]

However, The Goldman Sachs Trading Corporation did not terminate its trading activities in its own stock on February 7, 1929, but continued to trade in its existing shares until February 20, 1929, and in its new stock, after giving effect to the 100% stock dividend, until March 14, 1929. From February 7 to February 21, 1929, the old stock of The Goldman Sachs Trading Corporation fluctuated in price from \$207 to \$225.50 a share, or within the range of its approximate parity with the market value of the stock of Financial and Industrial Securities Corporation which ranged in price over the same period from \$133 to \$150 a share. Similarly, over the same period the market price of the new stock of The Goldman Sachs Trading Corporation created by the 100% stock dividend and which was admitted to trading on the New York Curb Exchange on a "when issued" basis on February 8, 1929, fluctuated between \$103 and \$112 a share, its approximate market parity with the stock of Financial and Industrial Securities Corporation.

Although after February 7, 1929 The Goldman Sachs Trading Corporation engaged to some extent in selling activities in its own stock, such selling activities were exceeded by its purchasing activities. Presumably the net purchases of its own stock supported the price of the stock at a market parity with that of Financial and Industrial Securities Corporation.[551] Tables 24 and 25 indicate the trading by The Goldman Sachs Trading Corporation from February 4 to February 20, 1929, in its original stock, and in its new stock from February 8, 1929, after the declaration of the 100% stock dividend to March 14, 1929.

Expressed in terms of the new stock of The Goldman Sachs Trading Corporation, after giving effect to the two-for-one split-up in its original stock, the volume of trading in such stock on the New York Curb Exchange from February 4 to March 14, 1929, totaled 1,140,400 shares. During the same period, The Goldman Sachs Trading Corporation purchased 557,670 shares of such stock, or approximately 50% of the total number of such shares purchased on the New York Curb Exchange, and sold 133,660 of such shares, or approximately 12% of the total volume of the stock sold on the New York Curb Exchange.[552]

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[549] Op. cit. supra, note 438, Commission's Exhibit No. 1687.

[550] Id., Commission's Exhibit No. 1680A.

[551] The announcement on February 7 of the prospective 100% stock dividend would also presumably have a supporting effect on the market price of the stock of The Goldman Sachs Trading Corporation which that corporation had created as the result of its purchases of such stock between February 4 and February 7, 1929.

[552] Op. cit. supra, note 438, Commission's Exhibit No. 1678. The Goldman Sachs Trading Corporation, during the period February 4 to March 14, 1929, also sold over-the-counter 35,909 shares of stock which it had acquired in the open market. As the result, on March 14, 1929, the corporation held a total of 388,101 shares of its own stock which it had acquired as the result of its market activities. In addition, it had acquired the 98,000

From these figures it is apparent that The Goldman Sachs Trading Corporation's activities in its own stock were the substantial factor in the establishment and maintenance of the market value of its shares at a price equal to the market value of the shares of Financial and Industrial Securities Corporation on the basis of the ratio in which the shares of the two companies were to be exchanged under the final plan for the combination of the two companies.

TABLE 24.—*Trading in original shares of The Goldman Sachs Trading Corporation*

Trade dates (1929)	Trading by The Goldman Sachs Trading Corporation			Reported trading on the New York Curb Exchange				Ratio of trading to New York Curb Exchange volume	
	Purchases (shares)	Sales (shares)	Price range	Total sales (shares)	Price range			Purchases	Sales
					High	Low	Close		
								Percent	*Percent*
Feb. 4 (Monday)	53,200	—	$170 -$180	98,600	$181	$170	$178	55	
Feb. 5	42,300	—	178 - 179⅝	56,500	179⅝	178	179⅝	75	—
Feb. 6	9,100	—	178 - 191 193¼- 221	28,000	192¾	180½	187⅞	33	—
Feb. 7	69.800	4,500	[a]202 - 222 200 - 222¼	89,500	221½	194½	221	78	5
Feb. 8	28,000	2,000	[a]221¼- 222	31,900	222¼	220¼	222¼	88	7
Feb. 9 [b]	—	—	— —	—	—	—	—	—	—
Feb. 11 (Monday)	19,500	1,700	222¼- 224 [a]223 - 223⅞	22,500	224	222¼	224	87	8
Feb. 12 [c]	—	—	— —	—	—	—	—	—	—
Feb. 13	2,900	8,100	224 - 225 [a]224⅛- 225 225 - 225½	13,200	225	224	225	22	61
Feb. 14	6,700	4,600	[a]225½- 226 224¼- 225½	12,200	226	225	225½	55	38
Feb. 15	4,700	200	[a]226 —	5,100	226	224¼	225	92	2
Feb. 16	11,500	—	220¼- 224	11,600	224	220¼	220¼	99	—
Feb. 18 (Monday)	7,160	100	191½- 216 [a]207 — 207 - 217	23,500	216¼	190½	207	30	—
Feb. 19	2,400	700	[a]208½- 218½ 219 - 220¼	8,700	219⅞	207	216	28	8
Feb. 20	3,300	100	[a]221 —	5,000	221½	219	219½	66	2
Total	260,560	22,000	— —	406,300	—	—	—	64	5

[a] Price range on sales.
[b] Exchange closed.
[c] Lincoln's Birthday.

Source: Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1665.

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shares of its own stock which were included in the portfolio of Financial and Industrial Securities Corporation. These shares represented the two-for-one split-up of the 49,000 shares of original stock which Financial and Industrial Securities Corporation had acquired in December 1928. Finally, The Goldman Sachs Trading Corporation's holdings of its own stock as at March 14, 1929, were augmented by an additional 74,623 shares as the result of the conversion into its own shares of the 56,352 shares of stock of Financial and Industrial Securities Corporation which The Goldman Sachs Trading Corporation had accumulated as the result of its trading in the stock of Financial and Industrial Securities Corporation. (See note 543, supra.) To sum up, as a consequence of its trading in the stock of the two companies and of the acquisition of the assets of Financial and Industrial Securities Corporation, The Goldman Sachs Trading Corporation had, on March 14, 1929, acquired 560,724 shares of its own stock at a cost of $57,021,936 (op. cit. supra, note 438, at 16221–3).

TABLE 25.—*Trading in newly issued capital stock of The Goldman Sachs Trading Corporation*

Trade date (1929)	Traded by The Goldman Sachs Trading Corporation				Reported trading on the New York Curb Exchange				Ratio of trading by The Goldman Sachs Trading Corp. to New York Curb Exchange volume	
	Purchases (shares)	Sales (shares)	Price range		Total sales (shares)	Price range				
			Purchases	Sales		High	Low	Close	Purchases	Sales
									Percent	*Percent*
Feb. 7[a]	—	—	— —	— —	—	—	—	—	—	—
Feb. 8	1,250	6,160	$112 –$114½	$112 –$115¼	6,800	$112¾	$111¾	$112	18	96
Feb. 11	3,200	18,100	111½– 113½	112¾– 114½	39,600	114½	111½	114	8	46
Feb. 13	1,400	11,800	113 – 114	113¼– 113¾	24,600	114	112¾	113½	6	48
Feb. 14	3,600	200	113 – 113¾	113¾– —	6,300	113¾	113	113¾	57	3
Feb. 15	200	400	113 – 113¾	113¾– 113⅞	6,100	113⅞	113	113	3	7
Feb. 16	5,900	—	110¼– 112½	— —	8,400	112½	110⅛	110⅛	70	—
Feb. 18	900	800	104 – 107¼	106⅞– 108¼	15,600	109¼	93	103	6	5
Feb. 19	—	8,700	— —	105 – 111⅝	25,000	111⅝	105	108½	—	35
Feb. 20	400	8,500	111 – 111½	110 – 112⅜	14,400	112⅜	110	110⅝	3	59
Feb. 21	2,700	300	109¼– 110½	110⅜– 111	6,600	111	109⅛	109¼	41	5
Feb. 25	—	600	— —	110 – 110½	5,000	110½	109¼	110	—	12
Feb. 26	—	1,000	— —	110 – 110½	4,300	111	109¼	109½	—	23
Feb. 27	1,600	600	109 – 109½	109⅝– 109¾	9,900	109⅞	108⅝	109½	16	6
Feb. 28	200	6,600	111½– —	109 – 112½	14,800	112¾	108⅝	112⅛	1	45
Mar. 1	800	18,300	111½– 111¾	111 – 112¾	36,800	113	111 (Ex.) (div.)	112	2	50
Mar. 2	2,000	1,500	110¾– 111½	112 – 112¼	6,500	112	110⅝	110⅝	31	23
Mar. 4	1,000	1,100	110 – 110½	111⅜– 111½	22,300	111½	110	110	4	5
Mar. 5	4,000	—	108½– 109⅞	— —	10,500	110	108¼	108¼	38	—
Mar. 6	1,500	—	107½– 108	— —	5,200	109	107⅛	108⅜	29	—
Mar. 7	500	—	106⅝– —	— —	5,300	108	106⅝	108	9	—
Mar. 8	400	—	106½ —	— —	6,600	108½	106½	107⅞	6	—
Mar. 9	2,200	—	107½– 109	— —	4,600	109	107⅛	109	48	—
Mar. 11	2,200	1,000	107 – 109	106 —	9,900	109⅜	106⅝	106⅝	22	10
Mar. 12	100	—	106½ —	— —	6,200	107⅝	106⅛	106½	2	—
Mar. 13	500	—	106 —	— —	9,000	107¼	105¾	107	6	—
Mar. 14	—	4,000	— —	106 —	17,500	109½	106⅝	109½	—	23
	36,550	89,660	— —	— —	327,800	—	—	—	—	—

[a] New stock not quoted until Feb. 8, 1929.

Source: Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1684.

However, in none of the public announcements of the impending combination of the two companies was there any reference either to the existence of, or to the trading activities in, the stock of both companies conducted by the joint account operated by The Goldman Sachs Trading Corporation and Delmar Capital Corporation, "the office corporation" controlled by Mr. Jonas. In fact, on February 18, 1929, three days prior to the stockholders' meeting to pass upon the plan, Mr. Jonas, in order to combat the efforts of several stockholders who were in opposition to the plan and who had formed a minority stockholders' committee and had publicized their opposition in newspapers,[553] ad-

[553] Id., at 16289. J. J. Farber, who stated he represented the holders of approximately 165,000 shares of the stock of Financial and Industrial Securities Corporation, had formed a committee of the company's minority stockholders and had retained counsel to institute a legal attack upon the impending combination of the two companies (*The New York Times*, February 17, 1929, p. 14).

dressed a letter [554] to the stockholders of his company which omitted to state facts necessary to make the facts stated not misleading.

It will be recalled that Delmar Capital Corporation, of which Mr. Jonas was the largest stockholder, was to have a half interest in and to share equally in the profits or losses of the joint account if the combination of the companies was not effected during the 30-day period of its activities. On February 18, 1929, the joint account had accumulated large blocks of the stocks of Financial and Industrial Securities Corporation and The Goldman Sachs Trading Corporation at a total cost of $49,547,689.62.[555] Unless the combination of the two companies was effected at the stockholders' meetings on February 21, 1929, Mr. Jonas, through the Delmar Capital Corporation, would be required to pay approximately $25,000,000 for his share in the stocks held by the joint account. Mr. Jonas thus possessed a special pecuniary interest in facilitating the sale of the assets of Financial and Industrial Securities Corporation to The Goldman Sachs Trading Corporation. Nevertheless, in his letter of February 18, 1929, to the stockholders of Financial and Industrial Securities Corporation, not only did Mr. Jonas fail to disclose the existence of the trading activities of the joint account, but he made the affirmative statement that "I have never personally owned, nor has anyone owned for me, a single share of Goldman Sachs Trading Corporation * * *." [556]

Mr. Jonas justified his failure to mention the $25,000,000 contingent interest of Delmar Capital Corporation in the joint account on the ground that it had never been been a personal commitment of his own since it had been his intention to transfer the participation of Delmar Capital Corporation in the joint account to Financial and Industrial Securities Corporation itself, if its combination with The Goldman Sachs Trading Corporation was not consummated. When interrogated on the contents of his letter of February 18, 1929, to the stockholders of Financial and Industrial Securities Corporation, Mr. Jonas testified: [557]

Q. That statement is not true.

A. What part of it?

Q. The statement: "I have never personally owned nor has anyone owned for me a single share of Goldman Sachs Trading Corporation, and the same applies to every other director and officer of Financial and Industrial Securities Corporation." That statement is not true.

A. I think it is true.

Q. This letter was sent on February 18, 1929, and on that date Delmar Capital Corporation owned $25,000,000 worth of Goldman Sachs stock; isn't that so?

A. You are talking about the trading account.

Q. Yes.

A. Well, I didn't. In the first place, as I have indicated, I had no recollection of knowing the amount at any time. Secondly, I didn't regard that as a holding we had.

Q. Well, it was an absolute fact, was it not, that until all of the stockholders of F. & I. had consented to the merger, Delmar Capital Corporation was a half

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[554] Op. cit. supra, note 438, Commission's Exhibit No. 1687.
[555] Id., Commission's Exhibit No. 1685.
[556] Id., Commission's Exhibit No. 1687.
[557] Id., at 16290–4.

owner in that account, and on February 18 the account had $47,000,000 worth of stock and Delmar owned approximately $23,000,000 worth of this stock? You and your associates owned $23,000,000 of Goldman Sachs stock on that date. There is no doubt about that.

A. I think there is a different way of putting it.

Q. How would you put it?

A. I didn't regard it that way unless the merger was not effected.

Q. The way this agreement is drawn it says that you are committed unless the merger is effected. Then you are relieved of your commitment. So you had a one-half interest in that 30-day account and the only way you would be relieved of that commitment is if the stockholders approved the merger; isn't that so?

A. Well, I never regarded that we had a commitment except the one commitment on the merger not going through.

Q. But the money was expended in that trading account and as it was being expended you had a commitment or an obligation to the extent of one-half of the money expended?

A. I didn't have it personally; it was the commitment of the corporation with which I was connected.

Q. You said, "I have never owned nor has anyone owned for me a single share of this stock," and the fact was that on February 18 Delmar owned $23,000,000 of it?

A. Of course, in your presentation, the holdings of Financial and Industrial might be said to be held for me personally because I was a substantial stockholder there.

Q. In the first place, you did disclose in this letter that F. & I. had this stock. In the second place, the Delmar Capital Corporation was a closed corporation owned by you and the very associates that you refer to there; isn't that so?

A. No; at that time the commitment of Delmar Capital Corporation was intended, as a matter of fact, to be for the Financial and Industrial Securities Corporation.

* * * * * * *

Q. I frankly don't understand how you made the positive unequivocal representation in the letter which was sent to the stockholders to persuade them to vote in favor of the merger on the representation that you didn't directly or indirectly own a single share of The Goldman Sachs Trading Corporation. That is the impression you wanted to give?

A. The impression I wanted to give was that there was no special consideration shown to any of the officers or directors of Financial and Industrial.

Q. If the deal didn't go through, the Delmar Capital Corporation would have had to take up $25,000,000 of The Goldman Sachs Trading Corporation stock?

A. The understanding among the directors of Financial and Industrial Securities Corporation was that if the deal did not go through, Financial and Industrial would take that stock.

As a result of this letter and a meeting held by Mr. Jonas with the minority stockholders of Financial and Industrial Securities Corpora-

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[558] On February 20, 1929, *The New York Times* (p. 32) reported that Mr. Jonas had held an open meeting with the minority stockholders of Financial and Industrial Securities Corporation who had been in opposition to the combination of the two companies. (See note 553, supra.) At this meeting counsel for the minority stockholders stated that the contents of the letter of February 18, 1929, written by Mr. Jonas, had explained the theretofore unknown aspects of the plan and had convinced them that Mr. Jonas was acting in the best interests of the stockholders. The minority stockholders then agreed to discontinue their objections to the sale of the company's assets to The Goldman Sachs Trading

tion [558] who had objected to the merger of the two companies, all opposition to the combination of the two companies was overcome, and on February 21, 1929, the stockholders of Financial and Industrial Securities Corporation voted to approve the sale of its assets to The Goldman Sachs Trading Corporation. On the same day, the stockholders of The Goldman Sachs Trading Corporation, in order to make the purchase possible, voted to increase the authorized stock of the corporation to 10,000,000 shares. The Goldman Sachs Trading Corporation thus acquired the assets of Financial and Industrial Securities Corporation, which had a market value of $117,500,000, by the issuance of 2,250,000 shares of stock having a market value of $108 a share, or a total market value of $235,000,000, twice the value of the assets which The Goldman Sachs Trading Corporation received for such stock.[559] This market value for its own stock, as has been described, was almost exclusively the creation of The Goldman Sachs Trading Corporation itself.

Moreover, the stockholders of the combined companies were unaware of the fact that approximately 24% of the combined assets of $235,000,000 of the two companies consisted of holdings of the stock of The Goldman Sachs Trading Corporation itself. As a result of its trading activities in its own stock and in the stock of Financial and Industrial Securities Corporation and of the acquisition of the assets of the latter company, The Goldman Sachs Trading Corporation held in its treasury, by March 14, 1929, a total of 560,724 shares of its own stock at a cost of $57,021,936. These shares were equivalent to 12½% of the 4,500,000 shares which the company had issued in the course of its existence. More importantly, the cost of these shares exceeded their asset value by approximately $23,000,000. In other words, $23,000,000

Corporation. However, the newspaper report does not indicate that Mr. Jonas had informed the minority stockholders of the market purchases which had been made in the stock of The Goldman Sachs Trading Corporation by the joint account in which his controlled company, Delmar Capital Corporation, was then a participant.

559 Op. cit. supra, note 438, at 16463. To appreciate the effect of this willingness of The Goldman Sachs Trading Corporation to pay twice the value of the assets of Financial and Industrial Securities Corporation in terms of the market value of its own stock, it is necessary to examine more specifically the assets of Financial and Industrial Securities Corporation. The assets of Financial and Industrial Securities Corporation on February 21, 1929, consisted primarily of $7,000,000 in cash; 98,000 shares of the new stock of The Goldman Sachs Trading Corporation having a market value of $108 a share or a total market value of $10,633,000; 179,247 shares of the stock of Manufacturers Trust Company with a market value of $264 a share or a total market value of $47,316,745; and blocks of the stocks of National Liberty Insurance Company, Baltimore American Insurance Company, and Peoples National Fire Insurance Company, having a total market value of approximately $41,000,000 (id., Commission's Exhibit No. 1683). For the $7,000,000 of cash held by Financial and Industrial Securities Corporation which Mr. Catchings conceded "was no different than anybody's cash" (id., at 16472) and would have purchased only 67,500 shares of the stock of The Goldman Sachs Trading Corporation in the open market, The Goldman Sachs Trading Corporation issued approximately 135,000 shares of its stock having a market value of approximately $14,000,000 (id., at 16474–7). For the 98,000 shares of its own stock with a market value of $10,633,000 held by Financial and Industrial Securities Corporation, The Goldman Sachs Trading Corporation issued to Financial and Industrial Securities Corporation 196,000 shares of The Goldman Sachs Trading Corporation stock having a market value of $21,266,000. Moreover, the asset value of the stock of The Goldman Sachs Trading Corporation held by Financial and Industrial Securities Corporation was approximately $5,300,000, so that as the result of the combination of the companies The Goldman Sachs Trading Corporation acquired 98,000 shares of its own stock for a consideration, in terms of the

of the $235,000,000 of assets of the combined company represented a self-created artificial evaluation of its own stock. As Mr. Catchings conceded, this $23,000,000 valuation in excess of the actual asset value of the treasury shares represented only a self-appraisal by Goldman, Sachs & Co. of the value of its management ability. Moreover, Mr. Catchings conceded that at the time the company was accumulating these shares of its own stock he had no concrete plan for their disposition. Mr. Catchings testified: [560]

A. * * * Your question, as I understand it, is what does that $23,000,000 represent to me. I say that represents to me that part of the market price of the stock or the cost * * * which was in addition to the asset value and that it was part of the total market price of the stock. It could be used in sale or exchanged for property.

Q. You bought that stock?

A. You know perfectly well what it is; it is a premium on asset value.

Q. Now that premium is attributable or is paid for management.

A. It is paid for the possibility of making money.

* * * * * * *

Q. So you are not disputing that the ultimate management is the biggest single factor in the premium aspect?

A. Not bigger than business conditions, but I will say it is a great element.

Q. So that as a necessary conclusion to that statement it seems to me that Goldman, Sachs & Company was paying $23,000,000 premium for its own management; isn't that so?

* * * * * * *

A. Twenty-three million dollars premium on the stock, a considerable part of which was predicated on management of the corporation by Goldman, Sachs & Company. That is correct.

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market value of its own stock which it issued for such shares, equal to four times the asset value of the stock acquired.

The Manufacturers Trust Company stock in the portfolio of Financial and Industrial Securities Corporation had a market value of $264 a share, a price equivalent to approximately 3½ times its asset value of $74 a share (id., at 16487) and to approximately 36¼ times its current earnings (id., at 16497). Since the stock of The Goldman Sachs Trading Corporation issued for the assets of Financial and Industrial Securities Corporation had a market value equal to twice the value of the assets of Financial and Industrial Corporation, for each share of the stock of Manufacturers Trust Company held by Financial and Industrial Securities Corporation, there was issued by The Goldman Sachs Trading Corporation shares of its own stock having a market value equivalent to twice the market value of the stock of Manufacturers Trust Company. In other words, The Goldman Sachs Trading Corporation paid $528 a share for the Manufacturers Trust Company stock held by Financial and Industrial Securities Corporation, a figure equal to 7 times the asset value and 70 times the current earnings on the bank's stock (id., at 16495, 16497).

Finally, the portfolios of the National Liberty group of insurance companies consisted almost entirely of holdings in the aggregate of 76,000 shares of the stock of Manufacturers Trust Company (id., at 16499 and 16501). The stocks of the insurance companies themselves were selling at twice their asset value, so that roughly it may be said that the stock of the insurance companies at market values represented a valuation of twice the market value of the Manufacturers Trust Company stock which they owned; that is, a value of $528 a share. In effect, therefore, The Goldman Sachs Trading Corporation, by using its own stock having a market value twice that of the value of the assets of Financial and Industrial Securities Corporation, in return for such asseets acquired through the insurance companies an additional 76,000 shares of the stock of Manufacturers Trust Company at a price of $1,058 a share (id., at 16499–500), a price equivalent to 14 times its asset value and 140 times its earnings (id., at 16501).

[560] Id., at 16231–5.

Q. * * * Investment, to my mind, denotes investing in another person's ability, but I have difficulty in visualizing a corporation paying $23,000,000 premium on its own management.

A. I don't think you have much difficulty with that if you take into consideration the fact that the stock was actually used to acquire property from other people and actually sold for cash. I grant you it would be a silly thing to pay that premium for the stock and then retire it. I don't see any reason to do that, but to pay the premium for the stock and then use that stock to buy other property, or to sell it for cash, I don't think anything is wrong.

Q. At that time you had that position you had no assurance that you could dispose of that stock?

A. We had only a business expectation that we could be able to do it.

Q. So that at that physical point of time the situation was that you had a block of your own stock upon which you paid a premium of $23,000,000, which represented substantially your own management; isn't that so?

A. We have covered that point before. I say partially so.[561]

As has been stated, the stockholders of The Goldman Sachs Trading Corporation apparently never became aware of the substantial repurchases of its own stock which the company had made in connection with its acquisition of the assets of Financial and Industrial Securities Corporation. By September 1929, prior to the publication of any financial report to its stockholders, The Goldman Sachs Trading Corporation had succeeded in selling or exchanging for other securities all of its holdings of its own stock. As will be seen later, substantial losses were suffered by the company on the securities which it had acquired in exchange for its own repurchased stock.

The sales made of its treasury shares were made in connection with further market activities in the company's own stock. In March 1929 approximately 225,000 shares of the 560,724 shares of its own stock then held in the treasury of The Goldman Sachs Trading Corporation were sold at prices below the then current market price to W. C. Durant, who conducted trading operations in the stock of The Goldman Sachs Trading Corporation until July 1929. The Goldman Sachs Trading Corporation had knowledge of Mr. Durant's activities and to some extent shared in his profits and losses.[562]

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[561] The purchases by The Goldman Sachs Trading Corporation of its own stock at prices above the asset value of such stock is one of the few instances of this practice which the Commission's study disclosed (id., at 16235–6. See also Ch. III of this part of the report). In April 1929, the New York Curb Exchange amended its regulations for the listing of the securities of investment companies to require that listed investment companies agree not to effect repurchases of their own securities at prices higher than the asset value of such securities. (See Part Two (House Doc. 70, 76th Cong.), Ch. IV, Appendix F, p. 795.)

[562] The Goldman Sachs Trading Corporation, through the Ralph Jonas-controlled Delmar Capital Corporation as an intermediary, granted to W. C. Durant options to purchase a total of 450,000 shares of its treasury stock at prices below the current market price of the stock (op. cit. supra, not. 438, Commission's Exhibit No. 1688). Concurrently with the granting of these options to Mr. Durant, there was a sharp increase in the volume of trading on the New York Curb Exchange in the stock of The Goldman Sachs Trading Corporation. From February 14 to March 14, 1929, the daily average of the volume of trading in the stock was 12,000 shares. On March 15, 1929, the day the options were granted to W. C. Durant, the volume of trading increased to 187,200 shares and the market price of the stock rose 4¾ points (id., at 16335). On March 15, 1929 and March 19, 1929, the volume of trading in the stock was 93,200 and 55,900 shares, respectively (id., at 16336). Mr. Catchings testified that he was aware that Mr. Durant was trading in the stock of The Goldman Sachs Trading Corporation on those days (id., at 16336). By

By September 1929 the remainder of the shares of its own stock held by The Goldman Sachs Trading Corporation was exchanged for the securities of various investment banking firms, banks, and bank holding companies located for the most part on the Pacific Coast. On these investments, two of which were known to be of dubious value at the time they were made, The Goldman Sachs Trading Corporation eventually suffered substantial losses.[563]

As has been stated, the principal assets of Financial and Industrial Securities Corporation acquired by The Goldman Sachs Trading Corporation were large blocks of the stocks of the Manufacturers Trust Company and of the National Liberty group of insurance com-

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March 21, 1929, Mr. Durant had exercised his options to the extent of 200,000 shares. Delmar Capital Corporation, which had a half interest in Mr. Durant's activities, had turned over to The Goldman Sachs Trading Corporation $265,000 as its share of the profits in the accounts (id., at 16336–7).

Subsequently, Mr. Durant purchased an additional 50,000 shares of the treasury stock of The Goldman Sachs Trading Corporation (id., at 16338) and conducted further trading operations in the stock until July 1929 (id., Commission's Exhibit No. 1689). Between March 21 and July 24, 1929, Mr. Durant purchased 93,283 shares of the stock of The Goldman Sachs Trading Corporation and sold 67,269½ of such shares. On July 24, 1929, Mr. Durant held a balance of 26,013 shares of the stock of The Goldman Sachs Trading Corporation, which had cost him $3,004,419 and in the acquisition of which he had suffered a trading loss of $378,128 (ibid.). On July 24, 1929, The Goldman Sachs Trading Corporation repurchased the 26,013 shares of its own stock held by Mr. Durant at their cost to him plus one-half of the trading losses, or at a total cost of $3,193,483 (ibid.). The repurchased shares were exchanged by The Goldman Sachs Trading Corporation for various properties on the Pacific Coast. (See note 563, infra.)

[563] The Goldman Sachs Trading Corporation exchanged 334,055 shares of its treasury stock at their market value, approximately $34,000,000, for all of the then outstanding stock of Pacific Trust Company, a New York bank, and the real estate on which the bank was situated; Bond & Goodwin & Tucker, Inc., a California investment banking firm; Hunter, Dulin & Company, another California investment banking firm; Pacific American Associates, Inc., later known as Pacific American Company, Ltd., a California investment Company; and for large blocks of the stocks of Pacific Lighting Corporation and American Company, a California holding company owning all of the stock of American Trust Company, a California commercial bank (op. cit. supra, note 438, at 16726–31 and Commission's Exhibits Nos. 1737 and 1749). In connection with the exchange of shares of the stock of The Goldman Sachs Trading Corporation for the shares of both Hunter, Dulin & Company and Bond & Goodwin & Tucker, Inc., The Goldman Sachs Trading Corporation exacted guarantees from the stockholders of these companies that certain of the assets of these companies which were of dubious value would realize stated amounts on their liquidation (id., Commission's Exhibits Nos. 1743, 1750, and 1751). Subsequently, these stockholders of these companies, who were retained by The Goldman Sachs Trading Corporation to manage its Pacific Coast investments, were released from their guarantees at substantial losses to The Goldman Sachs Trading Corporation (id., at 16785–7). In the case of Hunter, Dulin & Company the loss suffered by The Goldman Sachs Trading Corporation was at least $385,000 and the loss on Bond & Goodwin & Tucker, Inc. stock was approximately $2,200,000 (id., Commission's Exhibit No. 1747).

By September 1929, most of these securities which, as has been described, were acquired in exchange for its treasury stock, were placed by The Goldman Sachs Trading Corporation in Pacific American Company, Ltd., which became the holding company for the Pacific Coast assets of The Goldman Sachs Trading Corporation (id., at 16727–31). In the same month The Goldman Sachs Trading Corporation acquired all of the remaining outstanding stock of American Company, which was also transferred to Pacific American Company, Ltd. (ibid.). By September 1929, The Goldman Sachs Trading Corporation had invested approximately $110,000,000 in the securities of the Pacific American Company, Ltd., and in the various companies which were transferred to it by The Goldman Sachs Trading Corporation (id., at 16731 and Commission's Exhibit No. 1736). By December 31, 1935, The Goldman Sachs Trading Corporation had suffered a realized and unrealized loss of approximately $88,400,000 on its investments in the securities of Pacific American Company, Ltd., and its other Pacific Coast properties (ibid.).

panies. By the middle of 1933 the holdings of these securities, which had been in the portfolio of Financial and Industrial Securities Corporation, together with additional blocks which had been acquired by The Goldman Sachs Trading Corporation from other sources, had been sold at an aggregate loss of approximately $102,170,000, nearly all of which represented a realized loss.[564]

[564] Op. cit. supra, note 438, Commission's Exhibit No. 1702. The stock of the National Liberty group of insurance companies was sold to the Home Fire Securities Corporation as early as April 1930, at a loss of approximately $24,000,000 (id., at 16565) in order to derive cash to meet $20,000,000 of bank loans which The Goldman Sachs Trading Corporation had incurred in 1929 (id., at 16561–3). The largest portion of the stock of the Manufacturers Trust Company was sold to Harvey D. Gibson and associates in January 1931 at a loss of approximately $57,000,000 (id., at 16567–9).

Chapter V

PROBLEMS IN CONNECTION WITH CAPITAL STRUCTURE

I. INTRODUCTION

A. Scope of the Chapter

This chapter will discuss the problems in the investment company industry which are created, or are substantially intensified, by certain patterns of capital structure. The single-security structure, by reason of its simplicity and the absence of disparity between the rights and privileges of security holders, does not present the problems which tend to be evolved from the multiple-security structure. Hence, this chapter will discuss primarily the abuses attributable to the multiple-security structure.

The discussion will be confined principally to investment companies of the closed-end type.[1] In the closed-end type of company no provision is made for the redemption or repurchase of shares by the company at approximately their net asset value on demand of the security holder. Companies of the "open-end" type, which do extend such a privilege to the stockholder, are almost invariably single-security companies[2] and are thus free from such problems as are traceable to complexity in capital structure.

Moreover, this chapter will deal primarily with investment companies of the management type,[3] including management investment companies proper (investment companies which diversified their portfolio holdings) and management investment-holding companies[4] (companies which had concentrated investments in particular companies sufficient to give some influence or control.) There are a few instances of investment companies with more than one class of security outstanding (both a senior and a junior security) which possessed "open-end" features. While these anomalies will be referred to in the appropriate connection, it should be understood that observations

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[1] For a discussion of the differentiation between open-end and closed-end investment companies, see Pt. One (House Doc. No. 707, 75th Cong.), Ch. II, pp. 21–34.

[2] The single type of participation in the open-end company is evidenced by a common stock or a certificate of beneficial interest. Affiliated Fund, Inc., one of the few open-end companies which issued debentures, is discussed infra, pp. 1872–3.

[3] This chapter does not treat, therefore, with fixed and semifixed investment trusts, installment investment plans, and face amount installment certificate companies, which generally issue only one class of security or certificate.

[4] For a detailed discussion of the nature of management investment companies proper and management investment-holding companies, see Pt. One (House Doc. No. 707, 75th Cong.), Ch. II, pp. 21–34. Most management investment companies proper and all management investment-holding companies are of the "closed-end" type.

of a general nature relative to the manner of operation and functioning of investment companies are intended to embrace only management investment companies proper of the closed-end type and investment-holding companies.

B. Definition of "Capital Structure" of Investment Companies

The "capital" or "capitalization" of an investment trust or investment company is the fund raised by the trust or company to devote to the purpose for which the trust or company has been formed. The capital may be entirely capital contributed or may be in part capital contributed and in part capital loaned.

In exchange for the cash, property, or services contributed to the investment trust or investment company, capital stock, evidencing a proprietary interest with respect to the company, or the equivalent (certificates of beneficial interest or participation in noncorporate enterprise), is issued by the trust or company. In exchange for the funds loaned to the company, if any, which increase the capital of the company, bonds or indentures are issued embodying a promise to repay the principal at maturity and to pay interest in the meantime. The capital stock and the instruments evidencing the long-term promises to repay constitute the "capital securities" of the company.[5]

The cash, property, or services contributed to the company are not all turned over on the same terms; nor are all capital loans advanced on identical conditions. Consequently, various classes of securities are issued conferring different rights and privileges. Some types of securities extend to the holder a right to vote with respect to the management of the company; some types prescribe a right to a fixed rate of interest; others accord a claim to the first profits of the company. All types of securities define the rights of its holders upon the liquidation or dissolution of the company. Where there is more than one type of security, the respective priorities in voting and in the assets and earnings of the fund are defined.

The term "capital structure," as technically understood, connotes the quantitative and qualitative character of the outstanding securities of a company; in substance, the capital structure discloses the type or types of claims and the nature of the participating interests which the company has conferred upon the holders of its various securities.

The company generally regards its entire capital as a single fund irrespective of the sources from which it is raised. Hence, the distinction between capital contributed to the company and capital loaned to the company, as well as the differences in the obligations undertaken by the company in consideration of obtaining the capital, although important from the point of view of financing policy and from the standpoint of the legal status of the respective contributors, is not generally reflected in the use of the fund. Although the British investment trusts have acknowledged to some extent the materiality of such considerations by attempting some conformity between the classes

[5] Promises to repay short-term loans are not generally considered capital securities because the money advanced does not constitute a sufficiently stable increase in the capital fund of the company, and the relationship between the company and the creditor is transient. It is not to be inferred that such promises may not constitute securities under the Securities Act of 1933.

of securities in their portfolio and the classes of securities in their own capital structure,[6] the American investment companies have not generally sought any such correlation.

The subject matter of capital structure as treated in this chapter is not limited to enterprises maintaining the corporate form. Investment companies under a noncorporate form of organization, such as the Massachusetts or common-law type trust, the joint stock company or even an "agency" relationship between contributor and management, frequently issue more than one type of security and thus present the same problem of capital structure as the more common form of incorporated company.

C. Classification of Investment Companies From the Standpoint of Capital Structure

All investment companies have common stock or certificates of beneficial interest outstanding.[7] Some investment companies have common stock only and but a single class of common stock which is designated at times simply as "capital stock." Other companies, in addition to common stock, have outstanding securities other than common stock, such as bonds, debentures, and preferred stock, or while having no securities other than common stock have more than one class of common stock, such as Class A common stock and Class B common stock.

The most significant classification of investment companies, from the standpoint of capital structure, is based upon this distinction:

(a) Companies which have but one uniform class of securities (common stock)—these constitute the single-security or simple-structure companies; and

(b) Companies which have more than one class of securities outstanding (bonds or preferred stock in addition to common stock, or several classes of common stock)—these constitute the multiple-security or complex-structure companies.

The importance of this classification is that in the single-security companies all the security holders have the same rights and privileges with respect to the management, the earnings, and the assets of the company, and the same obligations and liabilities; whereas in the complex-structure companies the several categories of security holders have widely differing rights and privileges, as well as varying obligations and liabilities. In the simple-structure companies all securities are of equal rank, while in the multiple-security companies there are senior and junior securities.

Investment companies with two or more classes of common stock (such as Class A common stock and Class B common stock) are included in the category of complex capital-structure companies because, while all the securities of the companies are designated as common stock, the several classes of common stock may be distinguished from each other by vital differences with respect to the right to vote and participation in earnings and assets.

[6] See the Commission's Report on Investment Trusts in Great Britain, pp. 39–42.

[7] In the common-law or Massachusetts type trust the securities are known as certificates of beneficial interest.

This classification of investment companies, for the purposes of this chapter, into single-security and multiple-security companies is substantially equivalent to the general classification of management investment companies by capital structure into "leverage" and "nonleverage" companies as set forth at the outset of this report.[8] The only distinction in the scope of the two classifications is that in the earlier chapter, referred to above, companies having only one class of securities but acquiring leverage by bank loans have been classified as "leverage" companies. Since the present chapter deals primarily with the significance of the more permanent features of capital structure, incidental leverage of uncertain duration is ignored in the present classification. Hence, companies which have only one class of securities, whether they have or have not bank debt, will be regarded as simple capital-structure companies while companies having more than one class of securities will be included in the category of multiple-security or complex capital-structure companies.[9]

D. Significance and Place of Complex-Capital Structure Companies in the Investment Company Field

The study of investment companies has revealed that the complex-capital structure has been an important element in fostering and facilitating many of the abuses which have characterized that industry in this country in the last decade. A number of major wrongs perpetrated upon the public investor have been made possible through the medium of the multiple-security capital structure.

The complex-capital structure constitutes so important a problem in the investment company field, not only because of its causal relationship to existent abuses, but because it is so common and widespread.

Before considering the classification and significance of the various types of securities to be found in the capital structures of investment companies and analyzing the specific abuses which may be traced to the complex-capital structure, it may be advisable to note that companies with a complex-capital structure have not only constituted the most numerous type in the investment field but have accounted for the major part of the capital invested in, and assets controlled by, that industry.

From the first appearance of investment companies to the end of the period reviewed, December 31, 1936, investment companies with a complex-capital structure have dominated the field. Practically all of the oldest closed-end investment companies and the major proportion of the subsequently formed closed-end companies have been partly financed through issues of either preferred stock or debentures or both, in addition to common stock. Not only in number of companies but in amount of assets controlled, the multiple-security company has played the leading role among closed-end investment companies.

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[8] Pt. One (House Doc. No. 707, 75th Cong.), Ch. II, pp. 28–9.

[9] Option warrants are securities. Hence, a company, while it has outstanding, in addition to a single class of common stock, an issue of such warrants, may be regarded as a multiple-security company. Cf. the testimony of Floyd B. Odlum (Public Examination, The Goldman Sachs Trading Corporation, at 17620): "I think a perpetual option warrant is nothing more than an additional class of stock." The significance of option warrants in both the "leverage" and "nonleverage" company will be discussed infra pp. 1895–8.

The closed-end companies constituted a majority in number up to the end of 1932. The value of the assets of closed-end companies were from 2½ to over 5½ times as much as the combined assets of all other companies at every year-end from 1927 to 1936, inclusive.[10]

To measure the significance of the complex-capital-structure company, the proportion of closed-end companies with this type of structure will be considered. Table 26 shows the number and market value of total assets, at the ends of the indicated years, of closed-end companies with a complex-capital structure and companies with a simple capital structure. Closed-end companies which were management investment companies proper and closed-end companies which were investment-holding companies have been separately treated in the tabulation:[11]

TABLE 26.—*Closed-end investment companies classified by capital structure*

Dec. 31	Investment companies proper				Investment-holding companies			
	Number	Percent of total number	Value of assets (000,000 omitted)	Percent of total assets	Number	Percent of total number	Value of assets (000,000 omitted)	Percent of total assets
1927								
Complex	56	92	$560	97	19	95	$870	99.8
Simple	5	8	15	3	1	5	2	.2
1929								
Complex	109	67	1,939	67	33	83	2,610	92.6
Simple	53	33	959	33	7	17	208	7.4
1932								
Complex	100	66	571	68	33	79	1,116	92.4
Simple	52	34	274	32	9	21	92	7.6
1935								
Complex	79	65	825	73	34	77	1,599	91.8
Simple	43	35	300	27	10	23	143	8.2
1936								
Complex	72	64	968	76	34	77	1,860	90.7
Simple	41	36	307	24	10	23	191	9.3

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[10] The following tabulation [a] shows, for the indicated years, the proportionate number of closed-end investment companies (investment companies proper and investment-holding companies) and the market value of their combined assets in relation to all the investment companies of which the total assets were known to the Commission within the period 1927 to 1936.

Closed-end companies as percent of all companies [b]

Year-end:	*Percent of number*	*Percent of assets*
1927	68	81
1929	73	85
1932	51	78
1935	45	74
1936	46	73

[a] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II, Table 17.

[b] Unclassified management companies were not included in the closed-end group, although most of them were of that type, so that the percentage of closed-end companies was actually greater than shown.

[11] This table is based on Table 19 in Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II; bank loan leverage companies with a single class of security have been reclassified as single-security companies.

Table 26 indicates that investment companies with a complex capital structure averaged roughly in number about 70% of the closed-end investment companies proper during the period 1927–36, inclusive, and about 82% of the investment-holding companies.[12] In market value of total assets, companies with a complex capital structure averaged roughly about 75% of the total assets of the closed-end investment companies proper and above 90% of the total of the investment-holding companies. If the two groups be combined, the complex capital structure companies constituted about 75% in number and 85% in value of assets of all closed-end management investment companies. With respect to the percentages of the industry represented at various year-ends by the closed-end companies,[13] it appears that over the entire period companies with a complex capital structure accounted roughly for some 42% of the number of all investment companies and for some 67% of their total assets. The proportions at the 1929 year-end stood at 51% in number and 68% in assets, respectively, and at the end of 1936 were 31% and 62%, respectively.

The importance of the companies with a complex capital structure is further indicated by the statistics which show the amounts received from the public by closed-end investment companies, compared with the amounts raised by other types of companies. For the entire period from 1927 to 1936, inclusive, closed-end companies, which were predominantly, as noted above, of a complex capital structure, sold nearly 73% of the total volume of issues floated by all investment companies, three times as large a volume of securities as the total sold by open-end companies, fixed trusts, and installment-plan companies combined.[14]

It should be noted that the popularity of closed-end management investment companies prior to the stock-market collapse in 1929 was in no small measure due to their "leverage," an incidental characteristic possessed by the common stocks of companies with a complex capital structure.[15] In 1928 and 1929 common-stock issues of such closed-end management companies sold in the market at premiums—at prices above their asset or liquidating value—due principally to the expectations of the "equity" shareholder of large profits from the use of the "senior" capital of the companies and the operation of leverage in favor of the common stock. However,

[12] These averages, although based on only 5 years of the period, may be considered representative.

[13] See note 10, supra.

[14] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, pp. 187–93, and Table 60.

[15] Briefly the asset value of common stock of a multiple-security company with senior securities (leverage common stock) rises faster than the rise of the market value of the total assets and falls faster than the decline in the market value of the total assets. This proportionate greater increase or decrease is due to the fact that the amount of earnings (in the form of interest and dividends on their securities) and capital (amount of assets to which these security holders are entitled upon dissolution) available for the senior securities cannot exceed a specified maximum, while no such "ceiling" exists with respect to the common stock, which is entitled to the remainder of the earnings and assets. The multiple-security structure is not unlike a "margin" account, with the senior security holders furnishing funds to be invested by the common stockholder and the senior security holders being entitled only to a fixed income return (corresponding to the brokers' interest charges) and only to a return substantially of the amount of capital contribution by these senior curity holders. For more detailed discussion of leverage see Pt. One (House Doc. No. 707, 75th Cong.), Ch. II, pp. 28–9.

with the market collapse in 1929, the leverage worked against these common stocks, their asset value and market value declined precipitously, and these shares sold at discounts—at market prices below asset value. The popularity of that type of company was thereby almost completely abated. From 1931 through 1936, the distribution of investment company securities was chiefly of the securities of the fixed and semifixed trusts and open-end management types, i. e., companies of the single-security structure.[16] Nevertheless, the distribution of closed-end management investment company securities prior to the market collapse at the end of 1929 had been so markedly in the securities of "leverage" companies that to the end of the period studied, December 31, 1936, multiple-security companies were still predominant in number and in amount of assets controlled.

II. CLASSES OF SECURITIES IN THE COMPLEX CAPITAL STRUCTURE

Before describing the variety of classes of securities to be found among the investment companies which possess a complex capital structure, the essential characteristics of the companies whose capital securities have been confined to a single uniform class of stock should be noted. In the corporate form of investment enterprise, the single class of security consists of identical shares of the common stock, while in the Massachusetts-type trust, the securities distributed to the contributors of the fund consist of identical shares or certificates of beneficial interest. The shareholders in both the corporate and trust form of the single-security company are the equitable owners of the net assets of the company and are entitled to all the profits and bear the entire risks of the business. In such companies there are no shareholders with prior dividend or special voting rights nor any bond or debenture creditors. In the corporate form of the single-security company, the common stock has also the sole right to vote with respect to the management of the company.[17]

An investment company achieves a complex capital structure when it has issued (a) a bond or debenture issue or issues in addition to the company's stock issues, (b) an issue or issues of preferred stocks in addition to one or more issues of common stocks, or (c) more than one class of common stock, such as class "A" common and class "B" common. For the purpose of this chapter, preferred stocks and those classes of common stocks which have a priority to earnings or assets over other common stock issues of the company are grouped in the category of "preference stocks." [18] Many companies possess a capitalization consisting of bonds or debentures, preference stocks and common stock. Table 27 classifies, as of December 31, 1935, management investment companies proper with a complex capital structure into three categories: (a) Companies with common stock and bonds; (b) companies with common stock and

[16] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. III, Table 60.

[17] In the Massachusetts type of trust, the trust indenture generally places the management completely in self-perpetuating trustees, and generally the shareholders do not have the right by vote to change the management.

[18] See infra (p. 1576) for the reasons for the classification of the Class A common stock among preference stocks and the Class B common stock as a residuary common stock.

one or more preferred stocks; and (c) companies with common stock, one or more preferred stocks, and bonds.[19]

TABLE 27.—*Number and total assets of closed-end leverage management investment companies proper, classified by type of senior capitalization as of end of 1935* [a]

Type of capitalization	Number of companies		Total assets	
	Number	Percent of total number	Amount (000,000 omitted)	Percent of total amount
Common and preferred stocks	50	63.3	$463.5	56.2
Common and preferred stocks and funded debt	20	25.3	290.8	35.2
Common stock and funded debt	9	11.4	70.8	8.6
Total	79	100.0	825.1	100.0

[a] At the end of 1935, 11 companies with assets of $67,800,000 had common stock and bank loans and were classified as leverage companies but not included in this table.

A. Funded Debt

Bonds preceded preferred stock in developing into an important factor in corporate capitalization in addition to common stock.[20] Bonds or debentures are obligations, issued in consideration of the receipt of cash or property by a company, undertaking to pay a specified amount on a specified maturity date and to pay a prescribed rate of interest in the interim. The bondholder or debenture holder is a creditor of the company. The bonds or debentures contain a brief summary of the provisions contained in an agreement (called the "Trust Indenture" or "Deed of Trust") entered into between the company (the obligor) and the representative of the bondholders (known as the Trustee), to which the holders of the bonds (payees) become parties by the acquisition of the bond.

Aside from the fact that the bonds or debentures are promises that the company will pay to the holder a fixed amount—the face or principal amount of the bond—bonds of investment companies, like those of any corporation, have two other particularly significant features. The bonds carry a fixed rate of interest payable periodically, which the bondholder is entitled to receive before the distribution of any profits or dividends to the holders of any other class of securities. Since the bondholder or debenture holder is legally a creditor of the company, he is not, as is a stockholder, a joint venturer in the corporate enterprise or owner of the equity of the company. As a consequence, the bond or debenture holder almost invariably is not entitled to any interest or participation in the profits, earnings, or assets of the company other than the amount specified in the bonds

[19] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II, Table 4. The table covers companies with assets at market value of $500,000 or more on December 31, 1935, which filed an answer to the Commission's questionnaire.

[20] Dewing, A. S., *Financial Policy of Corporations* (3d rev. edit., 1934), pp. 19 and 43. Graham, Benj., and Dodd., D. L., *Security Analysis* (1934), p. 153.

nor has he any vote in the selection of the management of the company.[21]

The long-term obligations of companies may be secured by the pledge of some property of the company, in which event the obligation is generally known as a "bond" or a "secured or mortgage bond"; or the obligation may be unsecured, a mere promise to pay resting on the general credit of, or faith in, the issuing company, in which case the obligation is usually known as a "debenture." The bonds and debentures, whether collateralized or not, are known as the funded debt of a company.[22] The funded debt of investment companies is usually the debenture type. Of 180 management investment companies replying to the Commission's questionnaire, 33 companies disclosed the existence of funded debt, represented by 47 separate issues. Of these, 33 issues were unsecured debentures, 12 were collateralized, and 2 with unsecured issues at the outset were subsequently collateralized. Most investment companies reserve a right to call in or redeem their bonds prior to their maturity; all of the indentures examined in connection with this study, except two, provided for redemption of the debentures upon notice. Usually, the redemption price or rate is in excess of the face amount, ordinarily from two to five dollars additional for each $100 face value, on a basis graduated downward as maturity approaches.

The most significant covenants of the indentures under which the bonds are issued are those which purport to protect the holders of the bonds and those which define the procedure by which the bondholders may seek to enforce their claims in case the corporation fails to fulfill its promises. The indentures for investment company bond or debenture issues vary greatly in their so-called protection features or provisions. All of the indentures examined contained some protective provisions. Most indentures contain a "touch-off" clause or provision—a covenant that the company will at all times maintain a certain minimum asset coverage for the bonds or a margin of assets over total liabilities.[23] In other words, the investment company undertakes to maintain a minimum prescribed ratio between assets and liabilities, a ratio which varied from 110% to 250% with the different companies. Of the indentures examined, 36 recited as an event of default a deficiency in the specified minimum of asset coverage for the funded debt. Some indentures contain provisions requiring the maintenance of a sinking fund to "service" the debentures on maturity. Of the indentures examined, seven had sinking fund provisions, while one had a reserve fund similar in structure for interest payments. Some contain provisions conditioning the issuance of additional debentures on the existence of a minimum ratio of assets to

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[21] Some state statutes provide that bondholders shall have some voice in the selection of management. In some investment companies the bond or debenture holders are given a vote (e. g., in G. E. Employees Securities Corporation). There are also a few instances of participating bonds, i. e., a bond which permits the holder to share the company's earnings with the stockholders, and a number of instances of bonds which bear warrants entitling the holder to purchase securities which will give their holder a voice in the management or a participation in the profits.

[22] In recent years funded debts which are not collateralized or secured and are therefore debentures have been at times called or referred to as "bonds."

[23] Corresponding requirements in the case of collateral trust bonds provide for the maintenance of a ratio between assets pledged with the trustees and principal amount of bonds outstanding.

funded debt, and, in some instances, to total liabilities of all kinds. All but four of the indentures examined provided for the maintenance of a ratio of assets to principal amount of bonds which are to be outstanding after any subsequent issues. This ratio of assets to funded indebtedness after issuance of additional debentures ranged from 200% to 120%. Other indentures forbid the issuance of additional debentures and/or securities with a prior lien on assets, or require a specified diversification of portfolio. There are at present no statutes requiring investment company to include any of these protective features in the indentures.

All indentures contain provisions purporting to define the procedure by which the bondholders may seek to enforce their claims in case the company fails to fulfill its promises. All but four of the indentures examined provided for acceleration of maturity of principal amount in event of default. Generally, there is an express stipulation that the trustee may declare the principal of the bonds due and payable in case the company fails to meet its interest charges or other conditions and the default continues for longer than a specified period, ordinarily a few months. In very few instances is it mandatory upon the trustee to act upon the expiration of the prescribed period of grace; in most cases the trustee need not initiate legal action against the company unless requested to do so by the holders of a specified percentage of the outstanding bonds (usually 25% or more) and unless provided with funds to cover the cost of litigation.[24]

Complexity in the capital structure of investment companies and diversity in rights of security holders is further increased by the fact that frequently companies issue different series of bonds. The several issues of a company frequently vary in date of maturity, rate of interest, the degree of protective safeguards, and order of priority.

B. Preference Stocks

Departure from a simple capital structure, consisting of a single class of common stock, may be achieved through the issuance of one or more of the numerous types of "preference stock." Of 160 closed-end management investment companies examined, 89 had issues of preferred stock, 67 companies had one class of preferred stock, while 22 had more than one class of preferred stock. Any issue of stock, whether called preference stock, preferred stock, or Class A common stock, endowed by the charter or bylaws of the company with special assurances, preferences, or limitations, falls into the category of "preference stocks."

Preference stocks have been called "compromise securities"[25] on the theory that that type of stock occupies an intermediate position between common stocks and bonds.

[24] The deficiencies of indentures generally, with respect to enforcement of prospective provisions, have been treated in the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VI (Trustees under Indentures), which furnished the basis for the Trust Indenture Act of 1939. A discussion of the limited remedial influence of the provisions of this Act upon the specific problems of complex capital structure in the investment field will be found infra.

[25] Dewing, A. S., *Financial Policy of Corporations* (3d rev. edit., 1934), p. 43. Graham, Benj., and Dodd, D. L., *Security Analysis* (1934), p. 153.

Although they are called stocks, it has been urged that from the standpoint of investment practice and the practical significance of the rights and status granted the owner, preferred stocks generally resemble bonds more closely than they do common stocks.[26] Like bondholders, holders of preference stocks are entitled, if earned and declared, to receive only specified rates or sums of money periodically and are usually not entitled to any share in the profits or earnings of the enterprise above the specified rate. Participating preference stocks, which are permitted a share in earnings in addition to the specified dividends, are more common than participating bonds. Nevertheless, an examination of issues of preferred stocks listed on the New York Stock Exchange, or recorded in listing applications, for the 50 years from 1885 through 1934, showed that 961 preferred issues out of 1,094 (88%) were entitled to receive fixed interest dividends only, with the common stock entitled to receive all profits after the fixed initial dividend on the preference stock—leaving 12% of the preferred issues entitled to some further participation in profits in excess of their fixed initial dividends.[27] Like bondholders, preference stockholders are entitled only to a specific dollar amount upon redemption of the shares, or upon dissolution of the company. Like bondholders, preference stockholders frequently have no initial and regular voting power nor right to participate in the selection of the management of the company.[28] Of the 89 investment companies issuing preferred stock, 24 denied such stock any voting power whatsoever, either regular or contingent; 25 companies granted to their preferred stock initial and regular voting privileges, while 40 companies allowed their preferred stock to vote only in the event of dividend defaults for a specified period.

However, the holders of preference stock, unlike bond or debenture holders but like common stockholders, have not the status of creditors of the enterprise, but have, in legal contemplation, an equitable proprietary interest in the company. While preference shareholders are not creditors—since the company does not undertake either to pay back the amount contributed or to pay the fixed dividends, unless the latter is earned and declared—on liquidation or dissolution the

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[26] See Graham, Benj., and Dodd. D. L., *Security Analysis* (1934), pp. 57 and 63.

Objections to the Conventional Grouping.—1. *Preferred Stock Grouped with Common.*—While this approach is hallowed by tradition, it is open to several serious objections. Of these the most obvious is that it places preferred stocks with common stocks, whereas, so far as investment practice is concerned, the former undoubtedly belong with bonds. The typical or standard preferred stock is bought for fixed income and safety of principal. Its owner considers himself not as a partner in the business but as the holder of a claim ranking ahead of the interest of the partners, i. e., the common stockholders. Preferred stockholders are partners or owners of the business only in a technical, legalistic sense; but they resemble bondholders in the purpose and expected results of their investment.

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From the foregoing discussion the real character and purpose of our classification should now be more evident. Its basis is not the title of the issue, but the practical significance of its specific terms and status to the owner. Nor is the primary emphasis placed upon what the owner is legally entitled to demand, but upon what he is likely to get, or is justified in expecting, under conditions which appear to be probable at the time of purchase or analysis.

[27] Stevens, W. H. S., "Stockholders' Participations in Profits," article in *The Journal of Business of the University of Chicago*, July 1936, p. 211.

[28] Preference stocks frequently have contingent voting rights conditioned upon specified defaults in payment of dividends, etc. The "senior" common stock, usually known as the Class A common stock, frequently has a constant voting power usually less in the aggregate than that of the residual common stock, usually known as Class B common or management stock.

preference shareholders are entitled to receive payment of the full par or stated liquidating value of their shares and accumulated unpaid dividends after the bonds are fully satisfied and before the common-stock holders can receive anything.[29] Unlike bonds but like common stock, preference stocks have no maturity date, and dividends are not deductible from earnings as interest is.

Realistically, the preference stockholder has few of the advantages of the common stockholder, such as the right to unrestricted profits and a voice in the management of the company, and is subordinated to the bondholders with respect to the type of advantage which the bondholder has over the common stockholder. However, the preference stockholder is usually entitled to a greater return, if earned, than the bondholders, and sometimes has a vote with respect to management.

Preference stocks of investment companies are generally in the form either of preferred stock or a special kind of common stock, called Class A stock to distinguish it from the ordinary residual stock known as Class B common stock, or management stock. The feature common to all varieties of preference stocks is a claim of priority on earnings. Two other characteristics are of almost universal occurrence among preferred stocks and of general occurrence among Class A stocks in the investment company field, namely: (a) a preferential lien on the assets of the company in case of the liquidation or dissolution of the business; and (b) the requirement that all lapsed dividend payments be paid before any dividends can be declared on the residual common stock.[30]

In most instances the preference stockholder is the recipient of ostensible protective provisions somewhat similar to those extended to bond issues. The most common safeguard is the stipulation that no additional bonds or preference shares be issued without the consent of the existing preference shareholders. Frequently, preference shareholders are granted an asset coverage provision—a stipulation that no dividends will be paid on the common stock if the net assets of the company fall below a specified ratio to the sum of the liquidation priorities of the outstanding preference stocks. Another provision fairly usual in connection with the preference shares of investment companies is a stipulation giving the preference stock voting rights after one or more lapses of dividends.[31] Such provisions have purported to provide the preference stockholders with a measure of safety in the event of poor performance of the company and to restrain the management, in the selection of which the preference stock investor

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[29] In investment companies, the preference stocks are usually of the cumulative dividend variety, i. e., the unpaid dividends accumulate and are entitled to be liquidated before anything is paid on the junior stocks. Of the 89 investment companies that issued preferred stock, 87 granted, while one denied, the benefit of cumulative dividends; one company failed to specify.

[30] For a discussion of the techniques on the part of the common-stock "control" by which such accumulations are eliminated, see infra, pp. 1790–5; see also the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII. For the number of companies granting cumulative dividends, see note 29, supra.

[31] Of the 89 companies issuing preferred stock, 40 companies extended a voting privilege to the preferred upon default in the payment of dividends for a specified period, ranging from 3 months to 2 years.

has no part, from activities prejudicial to the preference security holder.[32]

Diversity in the rights of security holders is naturally increased when, as has been fairly usual, investment companies have issued several issues of preference stock bearing different dividend rates and priorities and having varied limitations, privileges, and safeguards.

C. Convertible Securities

The foregoing description of the common stock, preference stock, and bonds does not completely disclose the variegated diversity of security interests which the complex capital structure investment company may present. Convertible securities—securities which can be changed from one type to another—have been, at various periods, popular in the investment company field. There are two general types of convertible securities: (a) Securities issued as one type or class convertible, under certain specified conditions, into some other type or class, such as bonds convertible into preferred and common stock or preferred stock convertible into common stocks; and (b) certificates (called warrants or options) representing a contract right to buy some form of corporate security on specific terms.

The convertible bond, or convertible preferred stock, enables the investor to retain greater security and the promise of regularity of income, while having the option, within the specified period, to exchange that status for that of the common stockholder if there occurs a market or asset appreciation of the common stock. Of the 89 companies issuing preferred stock, 30 had outstanding preferred issues which were convertible. When the security is a warrant to purchase a common stock, attached to a bond or to preferred stock, the investor can simultaneously retain the preferential position of his bond or preferred share and obtain, at his election within the stated period, common stock at a previously fixed price.

Convertible securities are generally issued by promoters to make the security more attractive and therefore more marketable. Whether or not the investor realizes the fact, a part of the sum he pays for the senior security is paid for the speculative interest he receives through the conversion privilege.

There is a species of warrant to purchase common stock, accompanying subscribed shares of common stock or issued independently, usually at the time of organization, called the option warrant (generally long-term or perpetual) which has been frequently distributed as partial compensation to promoters. In the inflated stock market of 1929, these options afforded the sponsors of investment companies an opportunity to make enormous profits.[33]

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[32] The extent to which these protective provisions have been effective in these respects is discussed infra.

[33] The method whereby, and the extent to which, conversion privileges in the complex capital structure of the investment company were turned by management interests to their personal advantage is noted infra. For a discussion of issuance of convertible securities and option warrants as instrumentalities of control, see infra, pp. 1899–1900.

D. Classification of Securities Into "Senior Securities" and "Equity Securities"

Since both bonds and preference stocks have rights to earnings and assets of the company superior to the common stock, the term "senior securities" is employed to distinguish both of these classes from the common stock. Common stocks, on the other hand, which have deferred claims to income and the assets of the company, are frequently termed "junior securities." Common stocks are frequently termed "equity securities" in contradistinction to the "senior" securities which have no share in the residual earnings or assets of the company.[34]

The other vital respect in which bonds and preference stocks, jointly, differ from common stocks is one in which the latter are favored: the right to participate in the management of the company. That the common stock is generally the repository of the power to select the management to the exclusion of the senior securities, is as significant for an understanding of the problems relating to complex capital structures of investment companies as the fact that the senior securities have a limited priority in distribution.

Every security of an investment company called a common stock should not, however, be deemed included in the category of "equity securities." There are the variants of common stock, such as Class A common stock, which have the attributes of priority in distribution and divestment of management rights characteristic of senior securities. When the problems and defects which the existence of senior securities in capital structure introduces into the investment company field are discussed, such a classified common stock will be considered as comprehended within the term "senior securities." On the other hand, the type of common stock, often designated Class B common stock,[35] or management stock, which has a deferred but unlimited claim to the distribution of earnings and assets, and the primary voting power, will be regarded as included within the category of "equity" securities.

III. ECONOMIC CONSIDERATIONS REGARDING SENIOR SECURITIES IN CAPITAL STRUCTURE OF AMERICAN INVESTMENT COMPANIES

Before proceeding from the general description of the various types of senior securities used by investment companies to the detailed discussion of specific problems, deficiencies, and abuses which have accompanied the issuance, repurchase, redemption, servicing, and default of such securities, the more important economic factors involved in the use of senior securities by investment companies will

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[34] Since preferred stocks have merely a first claim on the profits or earnings of the company and have not a creditor status, they are sometimes referred to as "equity" securities and their issue as "equity financing." For the purposes of this chapter, however, preference stocks will not be deemed to be included within the category of "equity securities."

[35] Sometimes the designation of the classified common stocks is reversed—thus in United Founders Corporation the Class A stock was the control class or management stock. See infra, pp. 1632–3.

be briefly considered. This section first contains a comparative description of the extent to which senior securities have been used by all corporate enterprises in the country and the proportion of total capital contributed by such senior securities. This discussion is followed by a comparison of senior security issues in American and British investment companies. The rationale of the use of senior securities by corporations is then summarized both from the point of view of supply—the factors which induce corporations to issue senior securities, and demand—the reasons which lead investors to purchase bonds and preferred stocks. There follows a summary of the economic bases of senior securities—the economic factors which are asserted to justify the use of senior securities in a sound scheme of corporation finance and an attempt is made to evaluate from an economic point of view the need for and the justification of senior securities in the capital structure of investment companies. Finally there are set forth several examples of considerations which are not primarily economic in nature but which aid in evaluating the justification for senior securities in investment companies.

A. Senior Securities in Capital Structures

1. AMERICAN CORPORATIONS GENERALLY

At the end of 1936, the relation between senior securities outstanding and total capitalization of American corporations in general varied greatly among the major industry groups (Table 28).[36] Against an over-all ratio of 38% for all corporations (excluding the financial and miscellaneous categories), the proportion of senior securities (bonds and mortgages and preferred stock) to total capitalization was as high as 67% for the service industries, 52% for transportation and other public utilities, and as low as 19% for corporations engaged in mining and quarrying, and 20% for corporations engaged in trade.[37]

A similar picture is presented by an analysis of 510 companies in 15 industry groups registered under the Securities Exchange Act of 1934 (Table 29).[38] The extreme diversity of the ratios of senior securities to total assets for the different industry groups is again apparent.

[36] A comprehensive, though rough, picture of the use made of senior securities by American corporations is provided by the relevant information collected by the Bureau of Internal Revenue, which is summarized in Table 28, reflecting the situation at or about the end of 1936. Corresponding basic figures for 16 subdivisions of the manufacturing industries may be found in Statistics of Income for 1936, Part 2, Table 6.

[37] Total capitalization in this table refers to senior securities (bonds and mortgages, and preferred stock) and common stock equity taken at balance sheet (book) values. The statistics of the Bureau of Internal Revenue, on which Table 28 is based, do not segregate bonds from mortgages.

[38] These companies are all relatively large organizations. The groups are the only industry groups for which such information is at present readily available. The figures in Table 29 are analogous to those presented in Table 28. Though the figures in Table 29 are less comprehensive than those contained in Table 28, they have an advantage from one point of view of excluding mortgages from senior securities.

TABLE 28.—*Selected balance sheet items and ratios as of December 31, 1936, or close of fiscal year nearest thereto, for all nonfinancial corporations submitting balance sheets in filing corporation income tax returns*

[Millions of dollars]

Industry	Number of corporations	Capital assets [a]	Senior securities: Bonded debt and mortgages	Senior securities: Preferred stock	Senior securities: Total	Common stock equity [b]	Ratio of senior securities to capital assets	Ratio of senior securities to capitalization [c]
Agriculture and related industries	7,126	1,214	244	74	318	1,195	0.26	0.21
Mining and quarrying	11,531	5,850	1,046	349	1,395	6,095	.24	.19
Manufacturing	85,350	20,690	4,256	5,530	9,786	32,937	.47	.23
Construction	14,574	493	135	75	210	721	.43	.23
Transportation and other public utilities: [d]								
Steam railroads	505	20,106	11,273	933	12,206	9,713	.61	.56
Other transportation and related activities	13,244	5,932	2,775	588	3,363	2,995	.57	.53
Electric light and power and combined electric light and gas	1,114	12,410	6,731	1,769	8,500	5,670	.68	.60
Telephone and telegraph	1,982	4,052	1,459	222	1,681	5,224	.41	.24
Other public utilities	3,822	5,173	2,381	355	2,736	2,579	.53	.51
Trade	130,073	3,615	998	1,271	2,269	9,165	.63	.20
Service	48,590	8,085	5,002	582	5,584	2,778	.69	.67
Total	317,911	87,620	36,300	11,749	48,049	79,072	.55	.38

[a] Land, buildings, and equipment, less depreciation and depletion.
[b] Common stock and surplus and undivided profits, less deficit.
[c] Senior securities and common stock equity.
[d] Only the total figures for this group are published in Statistics of Income for 1936; the breakdown given was obtained from the Bureau of Internal Revenue.

TABLE 29.—*Selected balance sheet items and ratios as of December 31, 1936, or close of fiscal year nearest thereto, for 510 corporations in manufacturing and trade registered under the Securities Exchange Act of 1934*

[Millions of dollars]

Industry	Number of corporations	Capital assets [a]	Senior securities: Funded debt [b]	Senior securities: Preferred stock	Senior securities: Total	Common stock equity [c]	Ratio of senior securities to capital assets	Ratio of senior securities to capitalization [d]
Manufacturing:								
Food and related products	86	1,194	285	462	747	1,595	0.63	0.32
Tobacco products	19	69	58	126	184	589	2.67	.24
Beverages (excluding breweries and distilleries)	7	16	0	7	7	61	.44	.10
Chemicals and allied products	42	808	39	243	282	1,405	.35	.17
Oil refiners with producing facilities with assets over $50,000,000 each	17	3,729	379	166	545	4,661	.15	.10

[a] Land, buildings and equipment, less valuation reserves.
[b] Includes a negligible amount representing installments of other noncurrent debt due within 1 year.
[c] Common stock and surplus, less deficit.
[d] Senior securities and common stock equity.

TABLE 29.—*Selected balance sheet items and ratios as of December 31, 1936, or close of fiscal year nearest thereto, for 510 corporations in manufacturing and trade registered under the Securities Exchange Act of 1934*—Continued.

[Millions of dollars]

Industry	Number of corporations	Capital assets	Senior securities			Common stock equity	Ratio of senior securities to capital assets	Ratio of senior securities to capitalization
			Funded debt	Preferred stock	Total			
Manufacturing—Continued								
Tires and other rubber products	14	266	168	219	387	206	1.45	.65
Leather and leather products	16	45	4	25	29	151	.64	.16
Building materials	23	326	25	63	88	386	.27	.19
Iron and steel producers with assets over $100,000,000 each	12	2,476	631	651	1,282	2,320	.52	.36
Machinery and tools	97	483	61	238	299	1,041	.62	.22
Automobiles, parts and accessories	68	743	18	232	250	1,471	.34	.15
Containers and closures (other than paper or wood)	8	266	5	58	63	343	.24	.16
Total manufacturing	409	10,421	1,673	2,490	4,163	14,229	.40	.23
Merchandising:								
Chain stores	71	457	18	104	122	805	.27	.13
Department stores	25	318	45	135	180	318	.57	.36
Mail order houses	5	133	0	24	24	412	.18	.06
Total merchandising	101	908	63	263	326	1,535	.36	.18

Source: Reports on industry groups of the Census of American Listed Corporations, a Work Projects Administration study sponsored by the Securities and Exchange Commission, December 1938–November 1939.

2. AMERICAN AND BRITISH INVESTMENT COMPANIES

American investment companies have made considerable use of senior securities, both measured by the absolute amount of senior securities issued and by the proportion of total capital funds raised through the issuance of debentures and preferred stock. Since 1927 American management investment companies proper have raised considerably over $1,000,000,000 through the sale of their senior security issues.[39] This amount represents over two-fifths of the total capital raised by leverage management investment companies proper and over one-fourth of the total for all management investment companies proper (closed-end and open-end).[40]

[39] See Pt. Two, Ch. III (House Doc. No. 70, 76th Cong.), Table 61. This figure is a rough estimate. Exact data are unobtainable since a considerable amount of senior securities was sold in units together with common stock. Furthermore, intercompany transactions, which amount to 30% of total sales, are included in this estimate to an extent which cannot be determined, although the proportion of intercompany transactions involving senior securities may be expected to be less than for common stock.

[40] If intercompany transactions were excluded both from total capital raised (Pt. Two, Ch. III, Table 60) and from senior securities, the proportion of total capital raised through the sale of senior securities might be as high as 50% for leverage management investment companies proper, and 35% for all management investment companies proper.

A group of investment-holding companies, which accounted for less than 40% of the estimated total sales for all companies of this type, raised over $300,000,000 through the sale of senior securities during this period or well over one-third of the total capital raised by these companies (Pt. Two, Ch. III, Table 61). Comparable information is not readily available for the other companies in this group.

The importance of senior securities in the capital structure of investment companies may also be measured by the relation between the amount of senior securities outstanding and the total capitalization (including surplus) at various dates.[41] For management investment companies proper, senior securities were about half of the total capitalization and surplus at the end of 1927 but declined to less than 40% of total capitalization and surplus at the end of 1929 as a result of unrealized appreciation in the portfolios of investment companies and large sales of their own common stock issues to the public. During the depression, common stockholders' equity almost disappeared as a result of the drastic depreciation in the market value of the portfolio; and, at the end of 1932, senior securities represented almost 90% of total capitalization and surplus.[42] The trend was reversed beginning with 1933, again due partly to portfolio appreciation and partly to new issues of common stocks and the absence of any additional issues of senior securities. As a result, senior securities accounted for slightly over 40% of total capitalization and surplus at the end of 1935 and for about 30% at the end of 1936.[43] This ratio of less than one to three of senior securities to total capitalization in investment companies [44] was somewhat lower than the average for all nonfinancial corporations but was higher than the average for corporations in manufacturing, mining, and in trade, indicating a smaller cushion for the senior securities of investment companies than for the senior securities of these other groups of corporations.[45]

These ratios take into account only the leverage in the capital structure of investment companies, reflecting the fact that part of the capital of the investment company is raised by the issuance of senior securities and that consequently an increase or decrease in the total value of net assets results in a proportionately larger increase or decrease in the total value of common stockholders' equity. However, the assets of investment companies consist to a large degree of common stocks of companies which in turn have senior securities in their capitalization. The common stock of investment companies, therefore, often has double leverage, provided partly by the senior securities of the investment company itself and partly by the senior securities of the companies whose common stocks are held in the in-

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[41] Total capitalization is obtained as before by adding the amount of senior securities (bonds and preferred stock) to the common stock equity; in this case, however, the common stock equity is based largely on the market value of the assets and is consequently a less arbitrary figure.

[42] These figures, based on market value of assets, combine leverage and nonleverage companies. For leverage companies alone, common stockholders' equity was negative at the end of 1932. See Pt. Two, Ch. II, Tables 29, 33, and 40.

[43] Figures from Pt. Two, Ch. II, Table 29 and Table 40. Management investment-holding companies show a lower ratio of senior securities to total capitalization than management investment companies proper for the first part of this period, but a higher ratio at the end of the period (Pt. Two, Ch. II, Table 43). For a statistical discussion of the extent of leverage in investment companies, see Pt. Two, particularly Ch. II, pp. 45–48, 70–1, and 75–7, and Ch. III, pp. 193–6.

[44] This ratio, which is much more volatile among investment companies than among other corporations, was considerably above one-third both before and after 1936.

[45] See Table 28. The over-all ratio for all nonfinancial corporations would be higher than shown in the table if mortgages (which are not found in investment companies) were excluded from senior securities.

vestment company's portfolio.[46] It is obvious, therefore, that the total leverage of the common stock of investment companies is almost always higher than the leverage measured by the relation between senior securities and common stockholders' equity of the investment company itself.

The degree of leverage prevailing in American investment companies, while high as compared with many other American industries, appears low in comparison to the prevalence of senior securities in the capitalization of British investment companies. British investment companies in 1935 had about as much preferred stock outstanding as common stock and slightly more debentures than either their preferred or common stocks.[47] The ratio of 70% of senior securities in British investment companies to total capitalization (not including surplus) was higher than the proportion of the total capital raised through the sale of senior security issues by American management investment companies proper and was above the proportion of the total capitalization (including surplus) which such senior securities in American companies accounted for at the end of 1935.[48] On the other hand, since British investment companies are almost entirely companies with senior securities,[49] they may be compared with American leverage management investment companies proper, for which the ratio of senior securities to total capital raised was over 40% while the ratio of senior securities to total capitalization (including surplus) was about 80% at the end of 1935.[50]

Moreover, in considering the higher proportion of capitalization of British investment trusts represented by senior securities it must be borne in mind that in 1935 the British trusts kept about 60% of their total portfolios in senior securities, while among American management investment companies proper fixed-interest-bearing securities and preferred stocks constituted less than 20% of the total portfolio at the end of 1935.[51] Investments in senior securities were much less prevalent in American investment companies—even among those having funded debt outstanding—than in the British companies, for the entire period studied.

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[46] The total degree of leverage can be calculated if the exact make-up of the portfolio of the investment company and the capitalization of all portfolio companies are known.

[47] See Commission's Report on Investment Trusts in Great Britain, pp. 26 and 36. These figures as a whole refer to the par value of capital originally contributed by the holders of these securities and to the extent that this is true the stated common-stock equity does not reflect surplus, and the ratio of senior securities to total capitalization (70%) is larger than the ratio that would be obtained if it were possible to value the common-stock equity at market in arriving at a figure for total capitalization as for American investment companies. Furthermore the ratio indicated for British investment companies is also larger than a ratio based on the actual amount of capital originally contributed since premiums (on common) received are not reflected in the par value of capital.

[48] The ratio given for British investment companies is more closely comparable to the ratio of senior securities to total capital raised, given above for the American investment companies, than it is to the ratio of senior securities to total capitalization (including surplus), also given for the American companies.

[49] See Commission's Report on Investment Trusts in Great Britain, p. 31.

[50] Id., p. 25, et seq. and Pt. Two of this report (House Doc., No. 70, 76th Cong.), Ch. II, Table 33.

[51] Op. cit. supra, note 49, p. 52; also see Pt. Two, Ch. VIII, Tables 169 and 217, and Pt. Two, Ch. II, Table 35. This ratio was only about 5% for investment-holding companies (Pt. Two, Ch. VIII, Table 219).

B. The Reasons for Issuance of Senior Securities

1. ISSUERS' POINT OF VIEW

Corporations have issued senior securities, in addition to common stock, in raising permanent funds for the conduct of their business for a variety of reasons. Senior securities were used to provide leverage for the junior money; to secure through the use of senior securities (which generally have no voting right) control over a much larger amount of total funds than those contributed by the common stockholders alone; and to tap, through the issuance of senior securities, sources of funds not available if capital financing were restricted to common stocks.

a. Creation of Leverage for Common Stock [52]

The creation of leverage for the money invested by the common stockholders probably has been in many cases a most potent reason for attempting to secure part of the capital funds through the issuance of senior securities which, although entitled to a preference with respect to all the assets and profits, are entitled to only a fixed and limited amount of these assets and a fixed and limited amount out of profits, both current and nonrecurrent, realized and unrealized. This incentive toward the issuance of senior securities is mainly speculative. The larger the amount of senior securities issued relative to the funds contributed by common stockholders the greater the possible gain to common stockholders—and, of course, the greater the risk that the entire junior money may be wiped out, at least temporarily.

b. Facilitation of Control

A high ratio of senior securities to total capitalization not only provides the common stock with a leverage factor but also reduces the amount of funds necessary to obtain the voting stock and therefore control of the corporation. Bonds and debentures almost never have voting rights, except in certain contingencies. The acquisition of control of large amounts of capital with a disproportionately small investment can also be achieved without the use of senior securities, through the creation of nonvoting common stock which is on a parity in all other respects with the voting common stock. However, such nonvoting stocks may have no sales appeal. While it is difficult or almost impossible to determine in a specific case whether senior securities were issued mainly to increase the leverage of the junior money or to permit control of large pools of capital with a relatively small investment, the distribution of the ownership of the common stock will furnish the answer in most cases. Whenever the common stock is closely held in large blocks it may be assumed that the facilitation of control was at least a contributing factor in the issuance of senior securities; when the common stock is widely distributed and large holdings rare, the desire for additional leverage probably was the dominating factor and may often be traced to the increased "sales appeal" of comon stock with high leverage during certain periods of our financial history.

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[52] For a more detailed discussion of the general problems of leverage see infra, pp. 1595–1664.

c. Tapping Fixed Income Savings Funds

One of the main reasons for the issuance of senior securities is to tap certain large reservoirs of savings which are generally unavailable for investments in common stocks. These reservoirs are at the present time, as far as fixed interest-bearing securities are concerned, mainly financial institutions (insurance companies, commercial banks and savings banks), nonprofit institutions (foundations, colleges, churches, etc.), and individual trust funds. In earlier periods a large part of the investment funds of individuals could likewise be tapped only by an offering of senior securities. The sales resistance of investors to common stocks which were regarded as speculative was avoided by offerings of senior securities with their purported safety and protective features.[53] Since the twenties, however, the reluctance of individual investors to invest in common stock, very pronounced until the World War, has diminished progressively.

2. INVESTORS' POINT OF VIEW

The paramount reason why some investors prefer senior securities, and in particular fixed interest-bearing bonds and debentures, to common stocks is, of course, the fact that these securities at issuance offer a promise of a yield fixed over a considerable period of time and also undertake the repayment at maturity or call of a fixed sum of money, equal to or slightly higher than the original investment. For certain types of investors senior securities are the only securities they can buy, either because of legal restrictions on their investment policies or because of the nature of their business. Individual investors generally are not under the same compulsion to direct their investments into senior securities. However, the desire to receive a steady income, together with the aversion to incurring the larger risks inherent in the ownership of common stock, have given senior securities a very pronounced sales advantage with many investors.

C. The Economic Bases of Senior Securities

1. THE MARGIN BETWEEN THE NET YIELD OF ASSETS AND NET COST OF SENIOR SECURITIES

One of the most important factors which may justify, on an economic basis, the issuance of senior securities is the existence of a margin of the net yield (the yield after expenses of operation or administration) of the assets to be purchased with the proceeds of senior securities over the cost of hiring the senior money. Unless such a margin exists, the issuance of senior securities will reduce the net profit of the issuing corporation (or increase its net loss) and will diminish common stockholders' equity. Clearly, senior securities under ordinary circumstances should never be issued unless the issuing corporation has good reason to believe that investment of the

[53] Senior securitie s in capital structures of investment companies were in many instances dictated by sales expediencies rather than economic soundness. Investors, by purchasing senior securities of investment companies, whose assets consisted mostly of common stocks, were investing indirectly in common stocks, even though they may not have known it and may have been averse to such type of investment.

proceeds of the senior securities will increase the net income of the issuer by more than the stipulated interest or dividend payments. In many cases, of course, these expectations prove to be unsound, with the result that the servicing of the senior securities absorbs part of the capital or earnings on capital belonging to the common stockholders. If payments of unearned interest and dividends on senior securities exceed total current net income, and are sufficiently long continued, they are bound to result in bankruptcy or voluntary liquidation.

American management investment companies proper over the period 1930–36 have earned an average annual current gross income [54] of between 4½% and 5% of their average total assets.[55] As expenses of operation have absorbed about one-fifth of current gross income, the rate of net earnings (before deduction of income taxes) is reduced to between 3½% and 4% per annum.[56] This rate obviously is far below the servicing cost of senior securities, since the bonds of investment companies were sold for the most part to yield between 5% and 5½% at issue price, while their preferred stocks were issued largely at yields between 5% and 6%, with 6% accounting for the great majority of the cases.[57] These yields must be increased by about one-twentieth, representing underwriters' commission,[58] to reflect the cost of the senior money to the issuing investment company.[59] Consequently the net cost of senior securities to the issuing company averaged over 5% for bonds, about 6% for preferred stock, and close to 6% in the aggregate.

When earnings are related to average invested capital rather than to average assets, the rate of earnings is substantially lower due to the fact that most of the capital was raised and invested in 1928–29

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[54] I. e., total income exclusive of capital gains or losses before deduction of expenses of operation or income tax.

[55] All earning rates given here, as well as elsewhere in this section for comparative purposes, are before deduction of interest paid. (See Pt. Two, Ch. II, Table 39.) The investment companies in the Atlas Corporation and The Equity Corporation groups are not included in the figures on which these calculations are based. Comparable data prior to 1930 are available only for a small number of companies.

[56] The rate of current earnings on average assets becomes somewhat lower, of course, when 1928 and 1929 are included, as a result of the low dividend yield on comon stocks for these years.

[57] Of 81 preferred stock issues of investment companies, outstanding at the end of 1938, 3 had a stipulated dividend rate of less than 5%, 12 had a dividend rate of 5%, 9 had a dividend rate of 5½%, 51 had a dividend rate of 6%, and 6 had a dividend rate of over 6%. Of 28 bond issues, 7 had an interest rate below 5%, 11 a rate of 5%, 8 a rate of 5½%, and 2 a rate of 6%.

Preferred stocks constituted a much greater part of the capitalization of American management investment companies proper than did bonds. (See Pt. Two, Ch. III, Table 61; and id., Ch. II, Tables 29 and 33.)

[58] See Pt. Two, Ch. III, Tables 67 and 68.

[59] The discounts below par or premiums above par at which senior securities were issued, and the premiums above par at which some of the issues were to be retired, also affect the cost of senior securities to the issuing investment company. As most issues of senior securities were sold to the public at prices only slightly above or below par, and as the differences between the offering price and par would tend to compensate in part, such deviations from par value probably had but a negligible effect on the average net cost of senior securities. However, an adjustment of the average net cost of senior securities for premiums above par at which some of the issues were to be retiied would tend to increase, though only very slightly, the cost computed above.

when security prices were very high.[60] Doubtlessly, therefore, for the period of actual operation of American investment companies, the rate of current net income was far below the cost of senior money.[61] In other words, whether the rate of current net earnings of investment companies is calculated on the basis of original investment or changing market value of assets, the "margin" did not exist, as the rate of current net earnings was less than the rate of fixed charges on bonds and preferred stock.

There is no doubt that during the short period over which American investment companies have actively operated no positive margin has existed between current net earnings on assets and the cost of hire of senior money. While any consideration of the existence or the absence of such a margin for the period before 1927 is hypothetical in nature, as practically no investment companies were then in operation, it is of some interest for two reasons. It, first, provides an idea of the relationship between the current net earnings obtainable from an investment in diversified common stocks, such as investment companies hold, and the cost of senior money. Secondly, it indicates whether and on which assumptions investment companies in the late 20's could have reasonably expected, on the basis of the past, to derive a current margin from the issuance of senior securities. It then appears that for the period from 1871 through 1926 dividends on domestic common stock averaged only about 5.0% of their price, while the current yield on the direct investment of a constant amount of money in common stock in each year of the period would have averaged about 7.0%.[62] As operating expenses of investment companies during the past decade have absorbed close to one-fifth of gross income, it would seem that current yield from investment in common stock by investment companies (before income taxes, if any) would have averaged, over the period 1871 through 1926, in the

[60] Underwriters' commissions and loading charges would also tend to lower the rate of earnings on average invested capital—generally by one-twentieth to one-tenth—although they do not affect the rate of earnings on assets.

[61] The complete absence of any margin between net ordinary income and the cost of senior securities in recent years among American investment companies is shown by data available for 1938 and 1939. In 1938, among 71 investment companies with 111 issues of senior securities, only 3 companies with 3 issues had a rate of net ordinary income (after payment of expenses and taxes other than Federal income taxes) as high as the stipulated interest or dividend rates on their outstanding senior securities. The situation was not much more favorable in 1939, when among 45 companies with 69 issues only 3 companies with 3 issues had a rate of net ordinary income as high as the stipulated interest and dividend requirements on their senior securities. The negative margin between net ordinary income and cost of servicing senior securities was considerable: The average interest and dividend rate exceeded the average rate of net ordinary income of the issuer by about 3% in 1938 and by over 2½% in 1939.

[62] Cowles, Alfred 3rd, and associates, *Common Stock Indexes, 1871–1937,* pp. 372–3. The average annual yield of 5.0% on the average price of common stocks is of relatively little meaning from the viewpoint of an investor who bought stock at some time during this period and held this stock to the end of the period. The average annual yield of 7.0% on the investment of a constant amount of money in each year of the period is the simple average of average annual yields which an investor would have earned on his annual investments if he invested a constant amount of money in common stock in each year of the period and held all this stock to the end of the period. An investor who bought stock at some time during this period and sold out completely later in the period would be expected, on the average, to have had an average annual yield on his investment somewhere between 5.0% and 7.0%.

neighborhood of 4.0% or 5.6%, depending on the method of calculation. The first rate (4.0%) undoubtedly was below the rate at which investment companies, had they then existed, could have issued senior securities of any type. Even the second rate (5.6%) appears to have been below the probable cost of issuance of preferred stock, though it might have left a small margin over the cost of issuance of bonds. Thus not only did no margin exist between the current net yield and the cost of senior securities of investment companies during the period of their actual operation in this country, but it also seems likely that investment companies in general would not have earned such a margin over the half century preceding their rise.[63] In considering the economic basis of the issuance of senior securities of investment companies the absence of a margin during the period of actual operation and the difficulty in envisaging the emergence of such a margin in the near future are, of course, much more important than the apparent absence of a margin on current operations in a period of over fifty years during which investment companies were not yet in operation. Consideration of the hypothetical situation before 1927, however, is of some interest because of its corroborative character.

Since the cost of senior money was higher than the current net yield of assets after 1927, and apparently would also have been higher prior to 1927, the only possible justification for the issuance of senior securities—from the companies' and the stockholders' point of view—was the anticipation that nonrecurrent income (i. e., net capital gains) would be sufficient and steady enough not only to make up the deficiency of current net yield against the cost of servicing senior securities, but would also leave a net contribution to common-stock holders' income and equity. The nonrecurrent income, necessary to make up for the lack of the "margin" in current operations, was expected from two sources: first, the supposed compound-interest growth of the value of an investment in diversified common stocks of American enterprises; and second, the supposed ability of the managers of investment companies, aided by their economic and statistical staffs, to perform better than the stock market averages. The second source has thus far in the history of investment companies in this country, on the whole, turned out to be illusory. Over the period of actual operation, the performance of the average American investment company did not excel the performance of the usual stock price indexes (e. g., the Standard Statistics Company Index of 90 common stocks).[64] The expected long-term increase in the value of equities likewise has failed to materialize; in every year since 1931 the price level of common stocks, as measured by the usual stock price indexes, was substantially below that of the years 1928 to 1930 when most of the portfolios of investment companies were originally acquired.

[63] The cost of senior securities to investment companies over the period of their existence (roughly, from 1927) was close to 6%, and there is no obvious reason for believing that the cost of senior securities to investment companies would have been less than 6% over the years 1871–1926, assuming that the same proportion of bonds and preferred stock to common stock equity had been issued. As a matter of fact, available data for high-grade railroad bonds indicate that the yield of such high-grade, fixed-income securities was higher on the average for the period 1871–1926 than for the period 1927–37 (op. cit. supra, note 62, p. 492), although this may reflect a change in the investment quality of these issues as well as a change in long-term interest rates.

[64] For detailed discussion of the performance of investment companies, see Pt. Two (House Doc. No. 70, 76th Cong.), Ch. VI, pp. 463–92, and Appendix J, pp. 833–937.

Obviously, there have been periods in our history when capital gains, arising from increases in the price level of common stocks, would have more than compensated for the existence of a "negative" margin on current operations. This appears to have been true for the period 1871 to 1926 as a whole.[65] Capital gains, however, fluctuate so widely that the issuance of senior securities based on the expectation of such gains would seem to be an extremely tenuous procedure, as the experience of American investment companies over the period of their actual operation well illustrates.

The issuance of senior securities by American investment companies must, based upon conditions prevailing now as well as past experience over a fairly extended period of time, be regarded as a gamble on net capital gains. With the present structure of interest rates, the present level of stock yields, and the present costs of administration of investment companies, it does not seem likely that a net current income sufficient to cover the net cost of servicing senior securities can be obtained by investing either in diversified domestic bonds or preferred or common stocks.

In this connection a comparison with the British investment trusts, which have larger amounts of senior securities outstanding than American investment companies, is interesting. The net cost of issuing investment trust debentures or preferred stock is not very much lower in Great Britain than it was or would be in the United States.[66] But British investment trusts were at one time in a position to invest their funds in securities which generally had a yield considerably higher than that which they paid on their own senior securities. This was due, to a considerable extent, to the fact that a substantial proportion of their investments was in the public or corporate securities of foreign countries,[67] where a considerably higher yield prevailed than was common in Great Britain. For British investment trusts the issuance of senior securities was in effect a sort of interest arbitrage. In the United States the basis for a similar yield arbitrage has been lacking and is not likely to

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[65] Op. cit. supra, note 62, pp. 66–67. For this period there was an average rate of increase of about 2% per year in the market value of common stock holdings. This represents roughly the average increase over this period in the value of stock bought at the average price of one year and sold at the average price of the next year. There are, of course, other measures of the average annual rate of increase in the market value of common stock holdings over this period, each of these measures having a somewhat different meaning. For example, the simple average of the annual average rates of increase in the market value of common stock holdings resulting from the investment of a constant amount of money in each year of the period was about 3.6%, if it be assumed that all stock acquired in this manner was held to the end of the period. However, it may be noted that during years of rising prices, over the period of their actual operation, investment companies performed worse than the common stock "averages" (Pt. Two, Ch. VI, pp. 467 and 481), so that, if they had been in existence over the period 1871 to 1926, their capital gains would probably have been relatively smaller than the increase in common stock prices.

[66] The interest rate of British investment trust debentures varies between 3½% and 5½%, with 5% as the most frequent value, and with a general average slightly over 4½%; for preferred stocks the usual dividend rates are 5%, which is predominant, and 4½%, with a few cases ranging between 4% and 7%. (See the Commission's Report on Investment Trusts in Great Britain, pp. 28 and 31.)

[67] Id., pp. 48 and 50.

emerge in the near future.[68] In this country, the issuance of senior securities, supposedly following a British precedent, was and is a gamble on capital appreciation.

Although no margin between net current yield on assets and net cost of senior securities has been found for American investment companies as a whole, such a margin existed and still exists for numerous industrial corporations. This situation may require some explanation as the current income of investment companies consists predominantly of dividends on portfolio stocks of industrial corporations for a number of which a considerable margin may exist, and yet relatively few of the investment companies possess a comparable margin. The explanation lies primarily in the wide range in profitability among industrial companies in different industries, or of a different size, location, and quality of management, or possessing different degrees of monopolistic advantages. While the rate of current earnings also differs among investment companies, the range in variation among investment companies with diversified portfolios of the stocks of more or less the same corporations is very much smaller. Furthermore, the current yield of investment companies is considerably reduced by the cost of administration. An additional factor which aids in explaining the difference in "margin" between investment companies and many groups of industrial corporations is the lower net cost of issuing bonds or preferred stocks for the latter.[69]

2. STABILITY OF INCOME AND ASSETS

Senior securities require a certain minimum degree of stability of gross and net income of the issuing corporation. As interest and dividends on senior securities are, with minor exceptions, payable in fixed amounts, the issuance of senior securities and the continued existence of such obligations are justified only where the net income of the issuer is steady enough to give reasonable promise of meeting the charges on the senior securities in bad years as well as in good years. As a consequence industries such as the railroads, the electric, gas, and water companies (and, in Europe, the mortgage banks) which, because of the nature of their business, counted on a relatively stable amount of income at the time, have been the chief issuers of senior securities. For the same reasons industries with large cyclical fluctuations in income have in general made relatively small use of senior securities and particularly of bonded indebtedness.

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[68] It is true, of course, that most foreign securities sold during the twenties in the American market had current yields sufficiently high to promise investment companies some margin over the cost of their own senior securities. Several investment companies up to 1929 actually kept a considerable part of their assets in foreign securities. (See Pt. Two, Ch. VIII, pp. 562, 602–6, and Table 187.) The very unfortunate experience with many foreign issues sold in the United States, however, indicates that in the long run such an investment generally would not have produced the necessary margin but would have left investment companies with heavy capital losses.

[69] Another reason why current earnings on assets of investment companies are at a lower rate than in industrial corporations lies in the fact that industrial corporations usually do not distribute their entire current earnings as dividends. However, investment companies might be expected in the long run to be compensated for this relatively low current yield on assets by an increase in the value of their common stock holdings of the companies which retained earnings.

Steadiness of the value of assets is a fairly close attribute to steadiness of income as a prerequisite for the issuance of senior securities, since the value of assets over a substantial period of time is to a large extent determined by the earning capacity of the corporation. Steadiness of asset value may, however, be of much less importance than the fluctuations in income, as most of the assets of the great majority of the companies issuing senior securities cannot easily be sold in an open and continuous market.

Finally, it is evident that the basis for the issuance of senior securities becomes broader and more secure as the proportion of common stockholders' equity to senior securities outstanding increases. Obviously the smaller the proportion of total capital funds contributed by senior securities, the less will the current service on senior securities and the repayment of senior securities be endangered by declines in income and the asset value of the issuer.

American investment companies have conspicuously failed to meet the tests of steadiness of income or underlying assets. This result is hardly unexpected in view of the extreme fluctuations in corporate profits, dividends and stock prices which have characterized the last fifteen years during which investment companies have been active. While these fluctuations were extraordinarily large, the dividends and prices of American stocks have always been subject to violent fluctuations. During the period from 1871 to 1938 there have been seven instances when the prices of common stock—which have always constituted the chief assets of American investment companies—have fallen by 30% or more over periods of less than three years, including the decline of almost 90% between the fall of 1929 and the summer of 1932.[70] The marked swings in stock price movements, which existed even before 1929, should have dictated a very sparing use of senior securities.[71]

On the basis of book values, the fluctuations in the value of assets of investment companies have been proportionately much larger than for practically any group of manufacturing or trading corporations. These fluctuations are, however, partly due to the fact that the assets of investment companies may be and generally are periodically revalued on the basis of market prices, while revaluations (except for inventories) are relatively rare in other corporations.

The instability of the assets and income of investment companies is vividly reflected in the spotty record of service of senior securities of American investment companies during the past decade. Although only relatively few of the debentures issued by investment companies did not receive their interest, a substantial number of debenture issues, however, at one time or another were "under water,"—the total assets of the issuer became insufficient to cover the redemption value of the debentures.[72] The record of preferred stock issues of American investment companies is much worse. Of 117 issues of preferred stocks issued by 92 management investment companies [73] not less than 98, or 48% of the issues studied,

[70] Op. cit. supra, note 62, Chart 7 and pp. 66–7.

[71] For examples of the devastating effects of high leverage during this period, see infra.

[72] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II, pp. 77–8.

[73] These are the only companies for which this information is readily available.

passed one or more dividends payments between January 1, 1927 and December 31, 1935. That these defaults in dividends were not a negligible factor or soon remedied among these 98 issues affected is indicated by the fact that, on the average, dividends were passed for 15 quarters or nearly four full years. Since these preferred stocks were outstanding on the average for only somewhat over 7 years, it would appear that they failed to pay stipulated dividends during about one-half of their life.[74] In addition, these defaults do not include the instances when payments were made from paid-in surplus or capital surplus created by a restatement of capital, which were tantamount to merely a return of capital.

From 1927 to 1935, dividends aggregating about $82,200,000 were passed on the 98 preferred stock issues of the investment companies studied.

3. SALABILITY AND FLUIDITY OF ASSETS

Under these conditions the possibility of selling the assets underlying the senior securities becomes of considerable importance. Other things being equal, the issuance of senior securities may be better justified if a broad and continuous market for the issuer's assets exists. This type of market generally does not exist in the case of industrial corporations because plant and equipment are not easily salable. The owners of the senior securities in such corporations possess, in many cases, only the possibility of taking possession of the issuer's assets; and may either operate the corporations for their own account or dispose of the assets to a buyer able to operate them if relieved of much or all of the fixed charges. In either case previous senior security holders are reduced to the status of common stockholders for part or all of their holdings.

At least theoretically, the senior securities of investment companies meet the test of salability of the assets of the issuer to satisfy the claims of senior security holders. Contrary to the situation in most industrial or mercantile corporations where liquidation of assets is difficult and slow, the assets of an individual investment company (not including, of course, investment-holding companies) may be expected to be easily and rapidly salable without any substantial adverse effect upon the market for such assets. However, this theoretical possibility has been largely nullified in practice.

If most or all investment companies were to liquidate their security holdings within a short period of time, great difficulties would probably be encountered in liquidation except at extremely large price concessions. This situation would not be the result of an extraordinary thinness of the stock market but would be attributable to the fact that the portfolio holdings of investment companies of the common stocks of leading corporations now represent a considerable proportion of the total floating supply of such stocks.

The ready marketability and liquidity of the assets of an investment company may, however, under certain circumstances, be disadvantageous to senior security holders. Where the assets of a company consist of plant and equipment, the holders of the senior se-

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[74] Of the 98 issues studied, 14 passed between 1 and 4 quarterly dividends; 3 between 5 and 8 dividends; 6 between 9 and 12 dividends; 26 between 13 and 16 dividends; 36 between 17 and 20 dividends; and 13 passed 21 or more dividends.

curities, while in no way protected against losses resulting from adverse economic circumstances or mismanagement, are in no small measure protected against diversion of the assets. In investment companies, on the other hand, the assets in most instances, are the equivalent of cash and, with dishonest management, may be easily dissipated or with a new management or policy may be quickly and completely changed from their original nature on the basis of which their senior securities were sold.

D. Various Other Considerations Respecting Senior Securities in Investment Companies

1. MUTUALITY OF INVESTMENT COMPANIES

One concept of an investment company which has been greatly emphasized in the sales literature of investment trusts and companies in this country is that they are organizations akin to a mutual or cooperative enterprise of all participating investors.[75] Investment companies in this country have been generally represented, particularly in connection with the distribution of their security issues, as institutions by which numerous investors can pool their funds to obtain equally the benefits of diversification of risk and expert security management.[76] However, this concept of an investment company as a mutual enterprise cannot be reconciled with the existence of more than one class of security in the capital structure. The existence of different outstanding security issues creates different and conflicting rights in their holders and imposes conflicting duties on management. Since the risks, losses, and gains are not equally distributed among the holders of the various types of securities, actual conflicts of interest between the various types of security holders must arise sooner or later.

Furthermore, if, as asserted by some investment companies, the essential function of an investment company is to give an investor a substantial degree of safety through diversification and at the same time an opportunity to profit by the success of the performance of the company, the presence of "junior" and "senior" money is incompatible with this concept. Neither the senior securities nor the junior securities alone offer the investor both of these attributes. Neither the bondholder nor the preferred stockholder, ordinarily without a right to participate in surplus profits, derives any direct gains from the successful performance of the investment company beyond a certain point. These categories of security holders have an interest in these gains only to the extent that the company will be able to continue to pay the specified rates of return on the funds advanced, and to pay the ultimate claims of the senior securities at maturity or on liquidation. The common stockholder in a leverage investment company also fails to receive both a chance to make a profit and a substantial degree of security. His possible margin of

[75] The preferential tax treatment granted certain investment companies designated mutual investment companies was probably in no small measure based on the concept of an investment company as a "mutual" fund or joint or cooperative enterprise. See Section 48 (e) of Revenue Act of 1936 and essentially similar sections in the 1937 and 1938 Acts.

[76] See Part One (House Doc. No. 707, 75th Cong.), Ch. III, pp. 60–3 and Ch. II, note 6.

profit is greater but his investment is rendered more hazardous and speculative in character because the first earnings of the company must go to the senior security holders. In addition the wide swings which ordinarily occur in the market prices of common stocks are accentuated in proportion to the leverage in the investment company, and impel swings of greater violence in the market prices of the common stocks issued by these investment companies. These wide fluctuations of market prices, and consequent instability of values, of common stocks issued by leverage investment companies tend to attract speculative interests to these stocks and to discourage conservative investment interests.[77] Thus the function of supplying a single investment security which effectively combines the dual quality of safety and possibility of substantial profit is not served by the multiple-security investment company, which divorces these two objectives.

2. EFFECTS OF LEVERAGE IN CAPITAL STRUCTURES

Many problems are created by and many effects flow from the acquisition of leverage by an investment company through the issuance of senior securities of its own rather than through the purchase of leverage securities of others for its portfolio. For example, in many instances managements of investment companies with leverage in their capital structure have been tempted or forced to conform their multiple-security structures to the gyrations of the stock market, entailing marked changes in the capitalization of these companies and favoring special classes of security holders. During falling security markets or in anticipation of such conditions managements have attempted to avert precipitous declines in the asset value of the leverage common stocks of their investment companies, often largely held by these managements, by reducing the amount of senior securities outstanding.[78] This has frequently been effected through repurchases of senior securities at substantial discounts [79] and at times through the issuance of additional common stock in connection with exchange programs.[80] In periods of rising security prices or in anticipation of such conditions leverage investment companies have sought to increase their leverage factor by issuing more senior securities and thereby to accelerate the rate of increase in the asset value of the common stock. Often this increase of leverage has been effected through the acquisition of other leverage investment companies with a high leverage ratio.[81] Thus various significant practices of investment companies with their concomitant problems, discussed elsewhere in this report, are closely related to the presence of leverage capital structures.

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[77] Leverage accelerates the rise in the asset value of an investment company's common stocks as the prices of underlying portfolio securities increase and accelerates the decline in asset value as the prices of underlying portfolio securities decrease. The price index of leverage common stocks shows a much greater rate of change than the nonleverage index. See Pt. Two, Ch. IV, pp. 312–15.

[78] See infra, pp. 1708–1873.

[79] See infra, pp. 1749–74.

[80] See Ch. IV of this part of the report, pp. 1247 et seq.

[81] See infra, pp. 1708–1873.

While it has proved possible to change leverage in capital structures from time to time, the presence of leverage nevertheless has created certain rigidities not present in a single-security investment company. The leverage investment company, because of the difficulties involved in changing its leverage factor, has found itself unable to take full advantage of certain trends in the market, since certain types of investments, although otherwise desirable, might be inconsistent with the duty owed to the senior security holders of the investment company. In the single-security type of investment company leverage has been much more easily increased or decreased merely through the acquisition or disposition of leverage portfolio securities.

3. MULTIPLE-SECURITY COMPANIES AS MARGIN ACCOUNTS

Another type of consideration connected with the establishment of a multiple-security structure is that a situation is created analogous to, but lacking the protections which exist in, the ordinary margin account. A person purchasing senior securities in an investment company is in effect lending money [82] to the investment company for the use of the common stockholders to invest or to speculate in securities, similar in many ways to a broker's loan to a customer for use in a margin account.[83]

Yet the customary protection in this situation demanded by a broker [84] is in strong contrast to the protection usually afforded senior security holders by investment companies, even by those investment companies sponsored by brokers. The broker ordinarily keeps daily supervision over the status of a customer's margin account and can, long before the account reaches the point of being "under water" compel the customer to supply additional collateral. If additional collateral is not supplied, the broker can sell out the customer's securities in a few hours and fully protect his loan. When the asset value of the investment company has dropped to a dangerously low point, e. g., the preferred stock may actually be "under water"), the senior security holder, particularly the preferred stockholder, ordinarily cannot demand more collateral or that the underlying securities be sold and his claim paid off.[85] If he holds a bond he is almost entirely helpless until its due date, while if he holds a preferred stock, he must await the dissolution of the company, which dissolution is largely

[82] In the broad sense preferred stockholders may be characterized as lenders to the investment company, even though they do not have a creditor relationship. See supra, p. 1576.

[83] Both the senior security holder and the broker turn over a definite amount of money to the return of which they have an immediate or ultimate claim and are entitled to a specified and limited compensation for the use of that money, either in interest or dividends. In both cases the funds loaned are used to purchase securities, particularly common stocks.

[84] The volatility of and inherent risks to securities involved in margin accounts is recognized by the existence of various regulations promulgated by the Federal Reserve Board under the Securities Exchange Act of 1934 as to the amount and nature of credit which may be extended in such transactions.

[85] Theoretically this does not apply to investment company bonds with a "touch-off" clause. However, "touch-off" clauses are far less effective or timely for the investor than are rights in the usual margin agreement for the broker. In fact, means are often found to avoid the operation of "touch-off" clauses. See infra, pp. 1820–42.

determined by the holders of the common stock. Regardless of the extent to which the senior securities are "under water," the common stockholder usually continues to manage the funds on which the senior securities have a prior claim. In such a situation the multiple security structure tends to encourage a speculative policy on the part of the common stock management, since speculative transactions at such a point may, with the aid of leverage, reestablish positive values for the common stock and cannot do any substantial damage to the already existing negative values.

IV. NONCOMPATIBILITY OF THE RESPECTIVE INTERESTS OF SENIOR SECURITIES AND EQUITY SECURITIES

The complex capital structure thus embraces two broad categories of securities, senior securities and equity securities. The interests of these two categories are to a substantial degree competitive, and are in some significant respects noncompatible.

The senior security holders are interested in only such a margin of operating profit as will suffice to pay them the limited fixed annual return; the equity security holders are interested in a broad margin of profit, as all of the earnings except the fixed charges will inure to them.[86] The senior security holders have been sold their securities on the theory of safety of their principal, while the equity security holders have been sold their securities upon the theory of "leverage," greater play for their money, or speculative advantages. Yet the control of the fund, and consequently the safety of the senior security holders' investment, is almost invariably completely in the hands of the equity stockholders, to whom the fulfillment of the pledge of safety is wholly entrusted.

In the very fact that senior and equity securities have different rights, privileges, and protections, lies the seed of conflict of interest. In the investment company field the element of noncompatibility has been accentuated because the sponsors and promoters—investment bankers, security dealers, brokers, and other professional financing groups—have frequently constituted themselves primarily the holders of only the equity securities, while the senior securities were largely held by the public. The theory of senior securities in the capital structure presumed the existence of a large investment by the common stockholders as a buffer or cushion to insure the safety of the investment of the senior security holders and the regular payment of interest and dividends to them. However, in the financing of investment companies, senior securities apparently have been used for the purpose of obtaining from the public the major part of the capital contribution, while the control of the enterprise has been retained by the sponsors with small proportionate investments through ownership of common stock. Thus, the complex capital structure usually gives rise to another crucial element of conflict within the investment company field; the general public holding

[86] The occasional participating rights of senior securities will, of course, reduce the margin of profit of the residual common stock in those instances.

the major part of the senior securities has the greatest stake in the enterprise, while the sponsors or insiders, having a much smaller stake, control the enterprise.

The determination of the original capital set-up of the company, whether the structure was to be a simple structure or a complex structure, was, of course, solely in the control of the original sponsors. Likewise, the sponsors decided the portion of the senior or equity security which they would retain as their own investment, the portion to be distributed to the general public, as well as the proportion of the total investment to be contributed by the sponsors. The Study indicates that the sponsors have often chosen to take the position of equity security holders and to relegate to the public the position of senior security holders. This election on the part of the sponsors may suggest that significant advantages accrued to these sponsors by the allocation to themselves of the role of the equity security holders, with correlative disadvantages to the status of senior security holders, to which the public was largely relegated.

A. Control by Sponsors of the Nature of the Capital Structure

The sponsors at the very formation of an investment company have the power to determine the character of the capital structure, and the proportion of senior and equity securities that will be taken up by themselves and distributed to the public. These sponsors, under these circumstances, are able, with a proportionately small investment, to secure control of large pools of the public's funds.

Earl Bailie, a partner in the investment banking firm of J. & W. Seligman & Co. and chairman of the board of Tri-Continental Corporation, an investment company sponsored by that firm,[87] when questioned upon the method of determining the capital structure and the character of the securities of the investment company, testified:[88]

Q. So that Seligman & Company determined what the originating profit should be in the first place?

A. Yes, sir.

Q. And as you say, determined the corporate set-up?

A. Yes, sir.

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Q. Isn't the situation, Mr. Bailie, that you fashion the security and offer it for sale?

A. That is right.

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Q. And it is up to him to discover those things, but the whole set-up is arranged first and it is up to him to find out about it later?

A. It is inevitable. * * *

Sidney J. Weinberg, a partner in the investment banking firm of Goldman, Sachs & Co.,[89] when examined concerning the formation of

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[87] Public Examination, Tri-Continental Corporation, at 18515–6.

[88] Id., at 18527, 18686–7.

[89] Public Examination, Central States Electric Corporation, at 13410.

Blue Ridge Corporation by The Goldman Sachs Trading Corporation and Central States Electric Corporation jointly, testified: [90]

Q. But before the actual organization Goldman Sachs Trading Corporation—and I assume the members of Goldman, Sachs and Company—sat down at the table with Mr. Harrison Williams and decided what Blue Ridge should be, how it should be capitalized, and what its initial portfolio should be, and worked out all the details of this deal before Blue Ridge was even heard of by the public; isn't that so?

A. Yes; Mr. Catchings carried on the negotiations.

While admitting that the decision whether to create a simple or complex capital structure investment company rested with them, few sponsors would concede that the possibility of controlling a large fund through a small personal investment was the consideration which prompted the formation of the complex capital structure company. The sponsors offered various explanations for their decision in favor of the complex security structure.[91]

A survey of the many advantages, both pecuniary and strategic, available to the sponsors of a complex capital structure company will explain the attractiveness of that type of investment company to promoters and sponsors.

B. Advantages Initially Secured by the Sponsor of a Complex Capital Structure Investment Company

It has already been noted that there is a lack of identity of interest between the senior and equity securities, and that the conflict is intensified by the fact that while the senior securities are distributed among the members of the general investing public, the equity securities are, in a substantial degree, retained by the sponsors.

The advantages accruing to the sponsors through the organization of a multiple-security investment company and their retention of a dominant equity position in that type of company are numerous. Several of the most significant of the advantages to the sponsors inhere in the intrinsic nature of a capital structure containing both senior and equity securities. These advantages flow from the very

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[90] Id., at 13609. Hugh Bullock, vice president of Calvin Bullock, the sponsor, testified as follows in reference to the formation of International Superpower Corporation (Public Examination, Calvin Bullock group, at 3999):

> Q. Isn't the effect of all that you and Mr. Jaretzki did to completely set the stage for the public offering, in the way that you decided you wanted it? I mean, that happens in every corporation, I suppose, and it happened here? You set up the corporation and the corporation enters into certain agreements which give a monopoly or a semimonopoly over the sale of its stock for ten years?
> A. That is quite customary.
> Q. And then after you have it all set up, you sell your stock?
> A. If you can.

[91] For example, Fred Y. Presley, president of Second National Investors Corporation from its inception, testified that one of the considerations affecting the decision on capital structure was the salability of the securities (Public Examination, National Investors Corporation, at 4276):

> Q. * * * Do you remember what the factors were which determined the form which this capital structure took?
> A. Not precisely, but in general it seemed like a set-up which would be attractive to the investing public, and also a set-up which would be attractive to the junior security holders, a set-up which could be sold to the public.
> Q. That is to say, market conditions at the time were what weighed most heavily with you?
> A. That certainly would be an important part.

See also Ch. III of this part of the report, pp. 879–91.

character of the capital set-up. Hence, these advantages attach from the time of formation of the company and persist as long as the company retains that capital structure and the sponsors substantially preserve their position as the holders of equity securities.

These inherent advantages are to be distinguished from the opportunity presented the sponsors of the multiple-security company to adopt specific measures, practices, and investment policies which may be derogatory to the interests of the senior securities and favorable to the class of securities owned by them. The manifold and diverse over-reaching practices indulged in by some sponsors through the instrumentality of the multiple-security capital set-up will be described in detail in a subsequent part of this chapter. This section seeks to point out merely the advantages which the multiple-security form of capitalization, by virtue of its inherent nature, offers a sponsor as distinguished from the gains obtained from any specific or deliberate diversion of the funds of the senior security holder or general investor.

1. IMMEDIATE AND PROSPECTIVE CONTROL OF THE COMPANY AND A LARGE SHARE OF THE PROSPECTIVE PROFITS WITH A DISPROPORTIONATELY SMALL INVESTMENT

In the simple-structure investment company the relative amount of contribution to the initial capital of the company has significance inasmuch as the amount of original investment determines the relative right of each investor in the management of the company and in the profits of the enterprise,[92] because all purchasers of the securities of this type of company are granted an equal pro rata voice in the affairs of the company and interest in the earnings. The complex-structure company, on the other hand, recruits a large part of its capital from investors who often receive no voice in the affairs of the company and no right to share in the equity profits. Hence, the complex capital structure company is a suitable vehicle for promoters who desire by a small proportionate investment to achieve immediate and prospective control of the company and at the same time receive an inordinate participation in prospective profits. However, it must be noted that the common-stock capital, which is the cushion for the senior securities, does sustain the first shock of losses by the company.

This objective of control of large pools of public funds is attainable by the technique of organizing a complex structure company authorized to issue bonds or preference stocks in an amount several times as large as that of the common stock. Since the voting right may be and generally is extended to the common stock alone,[93] the

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[92] In most states promoters may receive an interest in the company greater than the proportionate amount of the tangible property contributed by them by obtaining, as a quid pro quo for promotion services, either stocks or options which give them exercisable claims on future earnings.

Of course, in case of a second issue of common stock at a price per share higher than the price of the original issue the rights of the purchasers of the second issue will be obtained for a contribution greater than that made by the holders of the original issue.

[93] In some instances the preference stock is also accorded a voting right. Since in such instances the voting right is granted per share, and not on the basis of contribution to capital, the total voting power inhering in the issue of preferred stock is generally very small in comparison with the voting power of the common stock.

sponsor need purchase and retain only such amount of common stock as will insure working control of the company. The senior securities and that amount of common stock not required for control purposes may be sold to the general investing public, which will then be contributing the major part of the investment in the company, but will normally receive no effective voice in the affairs of the company. The common stock, in addition to wielding control, will, in this type of capital set-up, be entitled to the entire earnings and profits of the company above the fixed interest charges and dividend yield on the senior securities.

This technique of allotment of senior securities and equity securities between sponsor and public has the effect of providing the sponsor with a "margin account," the funds for which are furnished by the public. While in the case of the ordinary brokerage margin account the broker has the power to "sell out" the account when it becomes undermargined, no such power inheres in the senior security holder of the investment company. In the absence of adequate provision with respect to asset coverage, particularly in the case of bonds, the "account" is not subject to further calls for margin even though it be completely "under water"—the assets of the company having diminished to a point where they are insufficient to cover the senior securities, with the common stock having a negative asset value. The sponsor, even under those circumstances, through his holding of the common stock, controls the account.

A number of illustrations of the disparity between the proportion of investment by the sponsor and the degree of control and participation in earnings are adduced below.[94]

a. Debenture or Preferred Stock and Common Stock Structure

(1) UNITED STATES & FOREIGN SECURITIES CORPORATION

United States & Foreign Securities Corporation is discussed in detail in order to illustrate the operations of "leverage" in the complex capital structure company.

On October 9, 1924, Dillon, Read & Co., a New York banking investment firm, organized a management investment company, called United States & Foreign Securities Corporation, with a complex capital structure consisting of first preferred stock, second preferred stock, and common stock. The certificate of incorporation [95] authorized the issuance of 250,000 shares of the $6 cumulative first preferred stock, 50,000 shares of the $6 cumulative second preferred stock, and $1,000,000 shares of common stock, all without par value. Gross proceeds of $30,000,000 were raised by the sale of the senior securities. The entire issue of 250,000 shares of the first preferred stock was sold to the public at $100 a share, for a total of $25,000,000. The entire issue of 50,000 shares of second preferred stock was taken up by Dillon, Read & Co. and closely associated interests at $100 per share for a total of $5,000,000.[96]

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[94] The discussion of some of the investment companies which illustrate such disparity has been deferred to subsequent sections where they are adduced to illustrate the more specialized abuses and defects of a complex capital structure.

[95] Public Examination, Unitd States & Foreign Securities Corporation, Commission's Exhibit No. 1160.

[96] Id., at 11721.

The common stock, which carried the control of the company and the right to all the surplus profits after satisfaction of prior dividend requirements, was treated in a somewhat unique fashion. Half of the 1,000,000 authorized and ultimately issued shares of common stock was set aside to accompany the senior securities. The public received 250,000 shares of common stock as a bonus with the issue of first preferred stock which it purchased for $25,000,000; the Dillon, Read & Co. interests received 250,000 shares of common stock as a bonus with the issue of second preferred stock which they purchased for $5,000,000. The remaining 500,000 shares of common stock were pre-empted by members of Dillon, Read & Co. at 20 cents a share, or a total purchase price of $100,000.[97] Thus, for $100,000 the Dillon, Read & Co. interests acquired 50% of the corporation's voting power and a 50% share in the prospective surplus profits of the company.[98]

Since the sponsor chose to retain the issue of second preferred stock at an investment of $5,000,000, its total investment in the enterprise amounted to $5,100,000.[99] The public contribution to the capital was $25,000,000. The public thus furnished 83.1% of the corporation's capital, for which it received a first lien on the company's assets to the extent of $25,000,000 invested and a right to 25% of the voting power and surplus profits; the sponsor contributed 16.9% of the corporation's capital, for which it received a secondary lien on the company's assets to the extent of all but $100,000 of the amount it had put into the company and 75% of the entire voting power and a right to 75% of all the surplus profits.

The preferred stocks had a limited return and a limited specified right in liquidation.[100] All capital gains above these limited dividends and liquidation rights would accrue to the equity of the common stock. Hense, the sponsor with an investment of $5,100,000 had $29.100,000 "working" for it.

Since the corporation actually received only $29,100,000 as net proceeds of the sale of all of its securities, $1,000,000 being paid to Dillon, Read & Co. and its associates as underwriting and selling commissions, the assets of the company were, at its very inception, inadequate to satisfy the liquidation claims of the senior securities.[101] While the common stock had no asset value at inception,[102] the availability of the $29,100,000 net proceeds for use in a rising security market, of course, presented the possibility of marked appreciation of the asset value of the common stock, 75% of which was held by

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[97] Report of the Senate Committee on Banking and Currency pursuant to S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.), p. 335.

[98] The preferred stocks had no voting rights except after the accumulation of 4 or more arrears in quarterly dividends (op. cit. supra, notes 95 and 97).

[99] However, Dillon, Read & Co. received $339,000 as its share of the underwriting fee.

The distribution of the preferred stocks to the public was effected by an underwriting syndicate composed of 300 participants headed by Dillon, Read & Co. The syndicate received $1,000,000 in fees, of which $339,000 went to Dillon, Read & Co. The total capital receipts of the company were thus reduced to $29,100,000. (Hearings before Committee on Banking and Currency, United States Senate, 73d Cong., Stock Exchange Practices, Pt. IV, p. 1566.)

[100] Op. cit supra, note 95.

[101] Op. cit. supra, note 95, at 11722.

[102] The leverage of the common stock (the ratio of the total value of the assets of the company to the asset value of the common stock) at the time of the organization of the company was, in mathematical terms, infinite. For a definition and analysis of the nature of "leverage" see Pt. One (House Doc. No. 707, 76th Cong.), Ch. I, p. 33.

the members of the sponsor group. In fact, the rise in security market prices from 1924 through 1928 increased the total assets of the company to approximately $52,950,000, with the result that on September 30, 1928 the common stock which had had no asset value at the inception of the investment company had achieved an asset value of $22,950,000. The block of the common stock acquired by the Dillon, Read & Co. interests, constituting 75% of the outstanding common stock, then had an asset value of $17,213,000.[103] It will be recalled that 500,000 shares of common stock (half of the entire issue) had been preempted by members of Dillon, Read & Co. for $100,000. These 500,000 shares now had an asset value of more than $11,000,000, an unrealized appreciation of 10,900%.

The sponsor interests had, upon the formation of the company, taken for themselves so large a percentage of the common stock that, at the end of 1928 they were in a position to sell to the public a part of their holdings at a most substantial profit while retaining enough common stock to preserve their undisputed control over the company. By a series of transactions during the period from December 20, 1928 through August 21, 1929, members of Dillon, Read & Co. disposed of 120,552 shares of common stock of United States & Foreign Securities Corporation, or 12% of the corporation's outstanding common stock, and received aggregate proceeds of $6,843,380. The methods employed in disposing of their block of stock closely resembled a secondary distribution operation. During the retail sales efforts and trading accounts managed by Dominick & Dominick, a brokerage firm, the market price of the common stock advanced, apparently due to the stimulation of investors' interest, to the extent that members of Dillon, Read & Co. who had originally purchased the common stock at 20 cents a share were enabled to sell the same at an average price of $56.80 a share. At the termination of these activities in August 1929, the Dillon, Read & Co. interests had received for the sale of a fraction of their common stock $6,843,380, which reimbursed them for their original investment of $5,100,000 in the corporation, and left them with an additional cash profit of $1,743,380.[104] In summary, by August 21, 1929 the Dillon, Read & Co. interests[105] had obtained a cash profit of approximately $1,700,000, retained the issue of second preferred stock and about 629,448 shares, or 62.9%, of the outstanding common stock. The retention of that percentage of common stock permitted Dillon,

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[103] Reply to the Commission's questionnaire for United States & Foreign Securities Corporation, Pt. IV.

[104] Hearings before the Senate Committee on Banking and Currency, pursuant to S. Res. 84 (72d Cong.), and S. Res. 56 and S. Res. 97 (73d Cong.), Pt. 4, p. 1686.

An attribute of the common stock of an investment company with high leverage is that it shows the same tendency toward rapidity of descent in market value in periods of declining securities prices as of ascent in periods of rising securities prices. By the end of 1931 the market price of the common stock (which had been taken up by the investing public at $58.60 per share) was $3.25 per share. Hence investors who had purchased the common stock disposed of by Dillon, Read & Co. were faced with a loss of $55.35 per share. By the end of 1935 this stock showed an improvement marketwise in that its price was then $13.75. Even at this higher value there was a disparity of $44.85 per share between the average price at which the public took up 120,000 shares in the secondary distribution and the market price at the end of 1935. (Reply to the Commission's questionnaire for United States & Foreign Securities Corporation, Pt. IV, Item 28, Table 7.)

[105] Associates and individual members of the firm are included within the designation "Dillon, Read & Co. interests."

Read & Co. to continue in undisputed control of the company and remain the major beneficiary of any future surplus profits.

Thus, by the end of 1928 the leverage characteristics given the company at its inception had exhibited their effects through the successful performance of the company, in producing a large equity interest for the common stock. The interest of Dillon, Read & Co. in the corporation had grown in that period from $5,000,000 to $22,213,000.[106] By the end of 1928, however, this very expansion of the equity interests served to contract the leverage ratio, i. e., to reduce the rate of prospective profit to the common stock, assuming a further similar advance in the value of the assets of the company. Assets of the company assignable to the equity shares ($22,950,000) approached the assets assignable to the fixed claims of the senior securities ($30,000,000). The sponsor had built up the "margin account" to the point where its own interest in the equity and in the second preferred stock constituted a very substantial margin for the public's first preferred stock. The sponsor interest no longer had $5 of the public's money working for each $1 of its own. The ratio had become almost one to one.[107] Dillon, Read & Co. then decided to form a new company with a capitalization which would restore the old ratio and high leverage. Clarence Dillon, president of United States & Foreign Securities Corporation, testified at the public examination of that company as follows:[108]

Q. What did you do then in 1928? You formed a new company.

A. That is correct.

Q. And that new company went back to your original more speculative situation, didn't it?

A. That is correct.

Q. Because your new company was formed on the basis of $50,000,000 of senior money to $10,000,000 of junior money?

A. That is correct.

Q. Which went back to the six-to-one leverage——

A. Basis.

Q. I have roughly figured it out that your consolidated company's leverage increased from under two to one to 3.7 to one.

A. Would you please say that again?

Q. I say, taking your combined senior money, after you had formed this new company, you had $75,000,000 of senior money——

A. That is right.

Q. And you still had $27,000,000 of junior money?

A. That is correct.

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[106] The respective interests of the public and the sponsor in the assets of the company on September 30, 1928, were as follows:

[In thousands of dollars]

	Total	Public	Sponsor
Original investment Oct. 9, 1924	[a] $30, 100	$25, 000	$5, 100
Net assets, investments at market, Sept. 30, 1928	52, 950	30, 737	22, 213
Percent of increase on original investment	76. 2%	23%	336%

[a] $29,100,000 net proceeds.

[107] Public Examination, United States & Foreign Securities Corporation, at 11734.

[108] Id., at 11772.

Q. Or total assets in those two companies of over $100,000,000?

A. That is right.

Q. And the $27,000,000 got the benefit of the earning power of the $100,000,000 or a ratio of 3.7 to 1?

A. That is right, if they were earning beyond the 6 percent or the 5 percent required.

Q. I am just trying to get the effect of the formation of this new company.

A. Yes.

Q. You started out with a leverage of 6 to 1 in the first company; you got up to October 1928 and you have made quite a lot of money for the common stock, so that your leverage is reduced down to two to one. You form a new company by taking $10,000,000 out of the first company on a 6-to-1 leverage basis again, and the net result is the combined leverage is 3.7 to 1.

* * * * * * *

A. Yes. I don't know just what you are trying to develop there, but from the point of view of the investor in the junior money, the greater the leverage the more unattractive the investment, because your risk is so great, so that from our point of view our interest is to have that leverage, as you call it, as little as possible, rather than as great.

In October 1928 Dillon, Read & Co. and United States & Foreign Securities Corporation jointly organized United States & International Securities Corporation as a subsidiary of United States & Foreign Securities Corporation. Its capital structure was quite similar to the original structure of its parent. The capitalization consisted of (a) $50,000,000 invested by the public in $5 first preferred stock with warrants for 500,000 shares of common stock exercisable at $25 per share, accompanied by 500,000 shares of common stock with only nominal value, and (b) $10,000,000 invested by the parent company in $5 second preferred stock, accompanied by 2,000,000 common shares, or four-fifths of the 2,500,000 common shares actually issued.[109]

The formation of this subsidiary illustrates the manner in which the complex capital structure facilitates corporate pyramiding, and, conversely, the intensification of the problems of the complex capital structure through corporate pyramiding.

The most obvious effect of the formation of the subsidiary was that the Dillon, Read & Co. interests obtained control over a fund twice as large as that of the original company without the investment of any additional new capital of its own. The creation of the subsidiary gave Dillon, Read & Co., through its original investment of $5,100,000, control over combined assets in excess of $100,000,000,[110] as of October 31, 1928. Another possible advantage achieved by the Dillon, Read & Co. interests was the acceleration of the rate of prospective profit to the sponsor's original investment by the formation of the subsidiary. Whereas in the parent company alone equity assets of $22,950,000 had $30,000,000 of senior securities investment

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[109] Ibid., and reply to the Commission's questionnaire for United States & International Securities Corporation, Pt. I (Exhibit D) and Pt. V.

[110] Op. cit. supra, note 107, at 11773. This figure represents the parent company's net assets at September 30, 1928, $52,950,000, plus subsidiary's capital of $60,000,000, less the $10,000,000 intercompany item.

to accelerate profits, in the combined companies an equity of $22,950,-000 had $80,000,000 of senior security money working for it.[111]

Thus, it is seen that the availability of the complex capital structure set-up to secure the advantages of control and a most substantial participation in the prospective profits through a comparatively small investment on the part of the sponsor, was apparent at so early a period in the development of the investment companies in this country.

(2) GENERAL AMERICAN INVESTORS COMPANY, INC.

The first General American Investors Company, Inc., hereinafter referred to as the "initial Company," was organized jointly by Lazard Frères and Lehman Brothers, New York investment bankers and brokers, in the State of Delaware on January 25, 1927.[112] On October 15, 1928, the Second General American Investors Company, Inc., was incorporated by these sponsors.[113] The first General American Investors Company, Inc. was merged with the Second General American Investors Company, Inc. on September 5, 1929, and the name General American Investors Company, Inc. was assumed by the combined entity, hereinafter referred to as the "Company." [114]

The initial company illustrates a complex structural set-up containing debentures, preferred stock, and common stock, which enabled the sponsors to obtain control and the right to participate to a most substantial extent in the earnings of the company.

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[111] Increase in leverage of parent common stock by formation of subsidiary:

Basis	Total net investment (asset value)	United States & Foreign Securities Corporation common stock (asset value)	Ratio of increase of common stock (asset value) to 1% increase in total asset value
Original paid-in capital of United States & Foreign Securities Corporation.	$29, 100, 000	No value (−$900, 000)	Infinity.
Net asset value as at Sept. 30, 1928—1 month prior to formation of subsidiary.	52, 950, 000	22, 950, 000	2.3 : 1.
Consolidated: Corporation and subsidiary as at Oct. 28, 1928.	102, 950, 000	22, 950, 000	4.5 : 1.

NOTE.—This computation is on the basis of the corporation's net asset value and not market value of the common stock in which a premium over asset value existed. The capital of the subsidiary is treated as fully paid at inception. The ratio on the consolidated basis is exclusive of warrants to purchase common stock outstanding on subsidiary's first preferred stock. The consolidated ratio is adjusted for the parent corporation's 80% participation in the subsidiary's surplus profits.

Dillon, Read & Co., by virtue of its status as holder of 75% of the equity securities of United States & Foreign Securities Corporation, would have stood to benefit to the extent of 60% of all surplus profits which might be made by United States & International Securities Corporation. However, as will be pointed out, by the end of 1931 the first preferred stock of United States & International Securities Corporation, for which the public had contributed $50,000,000, was "under water" to the extent of $40 per share, representing a $20,000,000 loss in asset value to the holders of the first preferred stock. Of course, the common stock of United States & International Securities Corporation held by United States & Foreign Securities Corporation had a negative asset value.

[112] Public Examination, General American Investors Company, Inc., at 5715, and Commission's Exhibit No. 517.

[113] Id., at 5715, and Commission's Exhibit No. 525.

[114] Id., Commission's Exhibit No. 528.

The initial company sold $7,500,000 of 5% debentures to the public. The debentures carried nondetachable warrants entitling the holders to receive, without cost, 75,000 shares of common stock. The sponsors purchased $1,500,000 par value of 6% cumulative nonvoting preferred stock (15,000 shares).[115] There were issued to the two sponsors for an assigned consideration of $300,000, 125,000 shares of common stock.[116] The sponsors paid $1,800,000 in all for the preferred stock and their common stock. As a result of this structural pattern, the sponsors for $300,000 received 62½% of the common stock, assuring them of complete control of the company and the right to five-eighths of the surplus profits, if there were any, of a company capitalized at $9,300,000. Of the total original investment in the company, the public contributed $7,500,000 or approximately 80%, and the sponsors $1,800,000 or 20%.

Second General American Investors Company, Inc. (organized on October 15, 1928), issued $10,000,000 par value of 6% cumulative voting preferred stock. The public offering price was 102½; hence, the gross proceeds to the company from this issue were $10,250,000.[117] The sponsors purchased 300,000 shares of common stock for $3,000,000, and the stockholders of the initial Company were permitted to purchase, share-for-share, 200,000 shares of common stock for $2,000,000.[118] The retention by the sponsors of their original five-eighths common stock ownership in the initial Company entitled them to the acquisition of 125,000 of the 200,000 shares offered the stockholders of the initial Company.

The public thus contributed $11,000,000 to the capital of the corporation for the entire preferred issue and approximately 15% of the total outstanding common stock. The sponsors contributed $4,250,000 for 85% of the common stock. It should be noted that the preferred stock was granted one vote per share, so the public investment of $10,250,000 in the preferred issue carried 100,000 votes, an amount obviously insufficient to affect the sponsor control.

As compensation for the distribution of the securities issue, the two sponsors received, in addition to a selling commission of $175,000, 25-year warrants to purchase a total of 500,000 shares of common stock of the Company at prices ranging from $10 a share to $20 a share.[119] The sponsors thus secured for a period of 25 years the power of increasing their proportionate share of equity stock in Second General American Investors Company, Inc., should they deem it desirable.

On July 9, 1929 a further distribution of securities of the initial Company took place. On May 28, 1929 the initial Company had declared a 100% stock dividend, thereby increasing the number of outstanding common shares from 200,000 to 400,000.[120] On the same date the initial Company retired all of the outstanding 15,000 shares of 6% preferred stock held by the two sponsors for a cash consideration of $1,500,000—the amount originally paid—pursuant to the terms

[115] Ibid.

[116] Id., at 5726, and Commission's Exhibit No. 517.

[117] Id., Commission's Exhibit No. 525.

[118] Ibid.

[119] Id., at 5747–50, and Commission's Exhibit No. 525.

[120] Id., at 5745–7 and reply to the Commission's questionnaire for General American Investors Company, Inc., Pt. V.

of an agreement under date of May 7, 1929 between the two sponsors and the initial Company and approved by the stockholders.[121] The agreement provided that the sponsors would surrender their entire joint holdings of 15,000 shares of preferred stock at par ($100) and accrued dividends (the redemption price being $120) and would underwrite without compensation an offering to common stockholders of the initial Company of rights to subscribe, on a share-for-share basis, to 400,000 common shares at $15 per share.[122] The original holding by the sponsors of 250,000 shares of common stock in the initial Company entitled them to secure an additional 250,000 shares at $15 a share, of the 400,000 shares of common stock offered, of which they availed themselves. During May and June 1929, while the preemptive offer was extant, the market price of the common stock carrying the right to the 100% stock dividend was approximately $80 per share.[123]

As a result of these steps, the sponsors were repaid their investment in the preferred stock and were left in undisputed control of a company the capitalization of which was almost $14,000,000 through an investment of approximately $4,000,000. They still retained their right to 62½% of all the surplus profits of the company.

In the case of each of these two investment companies, the sponsors were able to dispose of a part of their common stockholdings at substantial profits. The initial company, General American Investors Company, Inc., was originally created with $9,000,000 in senior securities as against $300,000 in common stock, a leverage ratio of 31 to 1. The $300,000 for the common stock had been contributed by the sponsors for 125,000 shares,[124] representing an average price paid of $2.40 per share. The effect of this leverage structure in a period of rising prices became apparent in the impetus give the equity stock marketwise. The market price of the common stock had ranged in 1928 from a low of 56⅛ in February to a high of 88⅜ in December.[125] These values represented substantial premiums over the stock's asset value of $9.26 per share at the beginning of the year and $25.39 per share at the close of the year.[126]

The sponsors, taking advantage of the high level in market price attained by the common stock in December 1928, disposed of 18,620 shares to the public for $1,365,221,[127] or at a profit of $1,320,533 over the original cost to the sponsors of these shares.[128] Thus, by disposing of this portion of the 125,000 shares originally taken down, the sponsors realized a profit of $1,065,221 over the cost to them of the entire block.

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[121] Reply to the Commission's questionnaire for General American Investors Company, Inc., Pt. V.

[122] Ibid., and op. cit. supra, note 112, at 5745–7.

[123] Derived from supplementary information supplied the Commission for General American Investors Company, Inc.

[124] See supra, p. 1604.

[125] Derived from supplementary information supplied the Commission for General American Investors Company, Inc.

[126] Reply to the Commission's questionnaire for General American Investors Company, Inc., Pt. IV (Item 28, Table 7a).

[127] Op. cit. supra, note 123. Subsequent to subscribing originally to 125,000 shares and up to this disposition, the sponsors had purchased 5,100 shares at average market prices and had sold 3,680 at about average prices. Some shares of the balance therefore might have been included in the 18,220 shares sold at this time. (Ibid.)

[128] As stated previously the cost per share was $2.40.

The investing public which had bought these shares from the sponsors was faced with severe losses both in asset and in market value in the period of deflation following 1929. By the end of 1932, the common stock of General American Investors Company, Inc., had fallen to a low of 13 cents per share in asset value.[129] This reflected an unrealized loss to the investing public on the 18,620 shares purchased from the sponsors in December 1928, in the sum of $1,362,-801.[130] With the general improvement in the value of corporate securities in the years following 1932, the common stock of General American Investors Company, Inc., showed an asset value of $16.15 per share and a market value of $11.25 per share by September 30, 1936.[131] On the basis of asset value the loss to the public would have been $1,064,508, while on the basis of market value the loss would have amounted to $1,155,746.

Again, in the case of Second General American Investors Company, Inc., the sponsors sold, at a sizable profit, a portion of their holdings of the common stock of this company. Although the leverage structure of this company was not as great as that of the initial corporation, the smallness of the floating supply of the common stock available for trading materially aided this stock marketwise. It will be recalled that Second General American Investors Company, Inc. issued at formation $10,000,000 in preferred stock which was taken up by the public, and 500,000 shares of common stock for $5,000,000, 425,000 of which were bought by the sponsors at the offering price of $10 per share.[132] In October 1928, the month of the company's formation, this common stock had a market value of $25.[133] By the end of the year it had reached $33 per share on the market,[134] a premium of $19.28 per share over its asset value.[135]

By disposing of 178,165 shares of this common stock for $3,004,-818,[136] the sponsors realized a profit of $1,223,168 above the cost of the shares sold.[137] The purchasers from the sponsors subsequently faced substantial losses.[138] They had paid an average of $16.87

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[129] Op. cit. supra, note 126. In September 1932 the original corporation had been merged with Second General American Investors Company, Inc., the common stockholders of the former receiving common stock of the latter, share for share (Public Examination, General American Investors Company, Inc., at 5745–6 and Commission's Exhibit No. 528).

[130] On the basis of a market value of 3⅝ per share as of this date (op. cit. supra, note 126), the loss to the investing public would be somewhat less. The market price of this stock at the end of 1932, when all market values had reached a low ebb, is an indication in itself of the potential value imparted to the equity securities by strong leverage capital structures. It is pointed out that at this time, when the asset value of the stock was but 13 cents per share, the market price of 3⅝ was still more than a point greater than the original cost of $2.40 per share to the sponsors.

[131] Op. cit. supra, note 126.

[132] See supra, p. 1604.

[133] Op. cit. supra, note 125.

[134] Ibid.

[135] The asset value was $13.72 per share at the end of 1928. (Op. cit. supra, note 126.)

[136] Op. cit. supra, note 125.

[137] The sponsors had paid $10 per share for this stock; see supra, p. 1604.

[138] Of the 178,165 shares sold at this time, 71,000 were sold to directors and 78,000 in large blocks to undesignated persons (Public Examination, General American Investors Company, Inc., at 5763).

per share. At the end of 1932 this stock had an asset value of but 13 cents per share.[139] By September 30, 1936 the stock had an asset value of $16.15 per share and a market value of $11.25 per share,[140] indicating potential loss at this date of $127,453 and $1,000,462, respectively.

The initial company was merged into Second General American Investors Company, Inc. on September 5, 1929, the necessary consent of stockholders having been given on September 4, 1929 by a two-thirds vote.[141] At that time the initial company had 800,000 shares of common stock outstanding, and Second General American Investors Company, Inc., had 500,000 shares outstanding. The 500,000 shares of common stock of Second General American Investors Company, Inc. continued outstanding while an additional 800,000 shares of its common stock were issued on a share-for-share basis in exchange for the outstanding shares of the initial company.[142]

No exchange of senior securities was made under the terms of the merger agreement. The company assumed $7,500,000 principal amount of debentures issued by the initial Company. The 100,000 shares of 6% preferred stock of the company remained outstanding without change.[143] The subscription warrants attached thereto, as well as the 25-year warrants representing the right to subscribe to 500,000 common shares at a price between $10 and $20 a share (held by sponsors), continued outstanding, no change being made in the general terms or exercisable prices.

It has been estimated that the sponsors acquired 925,080 shares of common stock of the two companies at a cost of $8,301,200.[144] (See Table 30.) Lazard Frères and Lehman Brothers together held 847,150 common shares of the corporation, after the merger of September 5, 1929, at a stated cost of $7,521,500.[145] At the time of the merger, the result of the financing operations was to leave the sponsors, by means of an investment of $7,521,500, in control of an investment company in which a total investment of approximately $28,500,000 had been made.[146] The 847,150 common shares of the Company held by the sponsors on September 5, 1929, after the merger, represented approximately 65% of the 1,300,000 common shares outstanding and only a slightly smaller percentage of the total voting power.[147]

[139] Op. cit. supra, note 126.

[140] Ibid.

[141] Public Examination, General American Investors Company, Inc., at 5745–6 and Commission's Exhibit No. 578.

[142] Ibid.

[143] Ibid.

[144] Derived from supplementary information supplied the Commission for General American Investors Company, Inc.

[145] Reply to the Commission's questionnaire for General American Investors Company, Inc., Pt. IV, Item 21.

[146] This is after deduction of $1,500,000, the cost of liquidating the 6% nonvoting preferred stock of the initial Company.

[147] This is after allowing for the voting rights of the $6 voting preferred stock.

TABLE 30.—*Acquisition of common stock of General American Investors Co., Inc., by sponsors*

Security	Date	Acquired by the sponsors (shares)	Price	Cost	Held at date indicated	
					Percent of common	Percent of voting control
6% nonvoting preferred [a]	Feb. 1, 1927	15,000 (all)	$100	$1,500,000		
Common [a]	Feb. 1, 1927	250,000	1.20	300,000	62.5	62.5
Common: [b]	Nov. 9, 1928					
Directly acquired		300,000	10	3,000,000		
Proportional amount estimated as taken up in offering of 200,000 shares to stockholders of the initial company		125,000	10	1,250,000	75.0	67.5
Common [a]—Proportional amount estimated as taken up in offering of 400,000 shares to stockholders of the company.	July 9, 1929	250,000	15	3,750,000	71.2	66.1
As underwriters	July 9, 1929	80	15	1,200		
Total:						
Preferred		15,000		9,801,200		
Common		925,080				
Less amount received from retirement of nonvoting preferred on May 28, 1929.				1,500,000		
Net amount in common stock				8,301,200		
Average per share cost of 925,080 estimated shares acquired.				8.97		

[a] Issued by the initial company.
[b] Issued by the Company.

(3) NATIONAL INVESTORS CORPORATION

The tremendous inflation possible in the market prices of the common stocks through leverage and pyramiding of investment companies, and the opportunity for huge profits for the sponsors, are illustrated by the National Investors Corporation group of investment companies. The rise in market prices of the stocks in this group and the profits to the sponsors were attributable to three basic factors: (a) The disparity in the original structural set-up of the company between the senior and equity capital; (b) the management option warrants which the sponsors awarded themselves for services in promoting the company;[148] and (c) the creation of a series of affiliates resulting in a pyramiding of leverages.

The original distribution of the securities of National Investors Corporation, organized on June 16, 1927 under the laws of the State of New York, consisted of 40,000 allotment units at $110 per unit

[148] The effects of the practice of issuing option warrants as compensation for organization and management services will be discussed below.

A company which has issued only one class of common stock but yet has option warrants outstanding, cannot fairly be considered a company of simple-security capital structure, as it possesses in fact two different types of securities.

composed of one share of 5½% cumulative preferred stock ($100 par value), one share of common stock at a stated value of $10, and one warrant to purchase 1½ shares of common stock over a period of 10 years at $10 per share to July 1, 1933, and thereafter at $2 more per share annually until July 1, 1938.[149]

The 40,000 shares of common stock, sold in the allotment units, contributing only $400,000 to the capital fund, were entitled to all the earnings and profits of the initial fund of $4,400,000 except the sum required to pay the 5½% dividend on the $4,000,000 of preferred stock.[150] A 10% profit on the capital would yield $5.50 to each share of common stock or more than 50% of its original stated value, while a 20% profit would earn each common share $16.50. The availability of such a disproportion of senior capital to work for the equity security holders tends to impart, in a rising security market, a special market premium to the common stock.[151] In the week ending July 6, 1929, the first week in which the common stock of the company was listed on the New York Curb Exchange, the price jumped from the opening price of $11¼ to $48 per share, rose to $77½ the next week and to $115⅛ the following week. By September 14, 1929 ths common stock had advanced to $391¾ per share, a 35-fold rise in two and one-half months.

The manner in which the allotment certificates were distributed contributed to the phenomenal rise in the market price of the common stock.[152] The original sponsors of National Investors Corporation were Fred Y. Presley, president throughout the period 1927–35,[153] the Guardian Detroit Company, Inc., of Michigan, and The Shawmut Corporation of Boston, Massachusetts.[154] The latter two institutions underwrote the issue of allotment units.[155] The allotment units were sold privately by National Investors Corporation itself and by the two underwriters to a group of banks and affiliated corporations and to the officers and directors of these institutions.[156] This type of distribution was planned by Mr. Presley as a means of building an organization to facilitate the sale of securities of additional investment corporations contemplated.[157] Hence, the small issue of common shares, 40,000 in number, was fairly closely held by banking interests desirous of retaining their position as distributors of affiliated company securities and thus disinclined to sell their common stock.[158]

In addition to the natural effect of the leverage element in the capital set-up and of the private distribution of the common stock, an intense demand for the common stock of National Investors

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[149] Public Examination, National Investors Corporation, at 4257–8 and Commission's Exhibit No. 419.

[150] Id., at 4271.

[151] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. IV, pp. 320–4, and Appendix H, pp. 805–18, for a discussion and statistics of the market premium upon the common stock of leverage companies.

[152] Op. cit. supra, note 149, at 4347–9.

[153] Id., at 4347–8.

[154] Id., at 4263–4.

[155] Id., at 4264.

[156] Id., at 4259, 4265, and Commission's Exhibits Nos. 417 and 418.

[157] Id., at 4253–5.

[158] Id., at 4273, 4349.

Corporation was generated by the operation of a trading account by Guardian Detroit Company, Inc. in the common stock of the corporation.[159] It should be noted that the trading account in the common stock of National Investors Corporation fulfilled a special function in connection with purchase warrants secured by the sponsors upon the formation of the company.[160]

Pursuant to the underwriting contract between Guardian Detroit Company, Inc. and National Investors Corporation, the former received, as partial consideration for the underwriting, purchase warrants to buy 100,000 shares of National Investors Corporation common stock on the same terms as those prescribed for the warrants sold as part of the allotment certificates.[161] Guardian Detroit Company, Inc. had agreed in a previous stipulation to reassign 50,000 of these warrants to certain individuals and firms associated with it in sponsoring the company.[162] Guardian Detroit Company, Inc., however, maintained its control of the purchase warrants assigned to the other parties by binding them to an agreement granting it the right to vote the stock obtained by the exercise of the options and the privilege of purchasing the options, or stock received from their exercise, at any proposed price of disposal, to others.[163]

By virtue of the control over these purchase warrants, Guardian Detroit Company, Inc. was thus able, for such a period as it deemed desirable, to restrict an increase in the supply of common stock through the exercise of the warrants while engendering an intense demand for common stock of National Investors Corporation by its trading-account activities. The appreciation of the market price of the common stock naturally brought with it a tremendous rise in the market price of the sponsors' purchase warrants. The creation of a high-priced market for the management's purchase warrants (and the stock acquired through their exercise) rather than for the common stock sold with the allotment certificates, was apparently the objective of the trading operations.

The price of the warrants secured by the sponsors as compensation for organizing National Investors Corporation followed closely the price of National Investors Corporation common stock on the New York Curb Exchange, ranging in price per warrant in July 1929 from \$61½ to \$110, in August from \$150 to \$214, and in September from \$255 to \$360½.[164] On the basis of the initial New York Curb Exchange market price, the total market value of the 100,000 management warrants was \$6,150,000. The peak price of \$360½ represented a possible profit to the holders of the 100,000 organizers' warrants of \$36,050,000, or 8.2 times the total amount of the initial capital of National Investors Corporation.[165] The minor sponsors were not in a position to profit fully from the extraordinary rise in the market price of the warrants and the common stock procured through their

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[159] Id., at 4378 and 4432. Guardian Detroit Company, Inc., also managed a bankers' pool or trading account in the common stock of National Investors Corporation's 3 affiliated companies (id., Commission's Exhibits Nos. 433 and 434).

[160] See infra, pp. 1613–14.

[161] Op. cit. supra, note 149, at 4263.

[162] Id., at 4268.

[163] Id., at 4344.

[164] Id., at 4347.

[165] Id., at 4271.

exercise because of the rights which Guardian Detroit Company, Inc., had retained in connection with the purchase warrants.[166] From November 15, 1928 to August 16, 1929, National Investors Corporation organized three affiliated investment companies, and Guardian Detroit Company, Inc. headed the underwriting group that sold approximately $48,000,000 of their securities.[167] To facilitate the sale of the last and largest of these issues (Fourth National Investors Corporation stock) and the contemplated sale of $47,000,000 of Fifth National Investors Corporation stock, officers of Guardian Detroit Company, Inc. and National Investors Corporation induced various original recipients of the organizers' warrants to make available some of their holdings at prices well below the market, for distribution to other influential banking interests.[168] Sponsors reassigned approximately 30,000 of the 50,000 warrants originally received by them at prices averaging around 25% to 35% of the market prices.[169] A considerable part of their remaining warrants they sold at substantial prices.[170]

Of the 50,000 warrants which had been retained by Guardian Detroit Company, Inc., 5,965 were given or sold to the secondary sponsors, whose aid was sought in the financing of the affiliated companies; [171] 12,570 warrants, equivalent to 75,420 shares after the six-for-one split-up, were sold back to National Investors Corporation at $5 a share.[172] Guardian Detroit Company, Inc. exercised part of the remaining warrants, sold some of the shares in the market and retained the balance of about 102,500 shares.[173]

The advantages of control and the right to the major part of the profits secured by sponsors through a senior-equity capital structure may be magnified by the use of part of the capital fund to secure the equity position in a newly created complex-structure affiliate. Such pyramiding of leverages has the effect of routing the surplus profits of the entire capital fund of the subsidiary to the equity interest in the subsidiary (held primarily by the parent company) and thence

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[166] The organizers were required to offer their option warrants to Guardian Detroit Company, Inc., for a period of 30 days before endeavoring to sell them, and in the event of conversion into common stock Guardian Detroit Company, Inc., retained the right to vote that stock (id., at 4344).

[167] Op. cit. supra, note 149, at 4319, 4333, and replies to the Commission's questionnaire for the National Investors companies, Pts. I and V.

[168] Op. cit. supra, note 149, at 4382–4.

[169] Ibid. and derived from supplementary information supplied the Commission for National Investors Corporation, letter dated July 29, 1930.

[170] Sloan Colt sold 4,500 warrants at prices ranging from $50 to $100 for a total of $285,000; George Murnane disposed of 3,500 warrants for a total of $414,850; Paul Cabot disposed of 3,500 warrants, receiving a total amount of about $355,000; Fred Y. Presley received $300,000 for warrants; James S. Ratray sold his 1,000 warrants early in July 1929 for $125,000 (Public Examination, National Investors Corporation, at 4269, 4339, 4341–3, 4351, and 4501). These were special prices, well below the market, by "insiders" to scattered banking interests—yet they represented a total profit to the sponsors who had received the warrants at no cost to themselves.

[171] Derived from supplementary information supplied the Commission for National Investors Corporation, letter dated July 29, 1930.

[172] Ibid. On October 8, 1929, both the common stock and the purchase warrants were split up 6-for-1 (Public Examination, National Investors Corporation, at 4357, and the reply to the Commission's questionnaire for National Investors Corporation, Pt. I, Annual Report, 1929).

[173] Reply to the Commission's questionnaire for National Investors Corporation, Pt. V, Item 52 (f).

to the equity interest in the parent company held primarily by the sponsor.

The National Investors Corporation group of investment companies exemplifies the effect of such pyramiding of equities. In fact, the primary object of the formation of National Investors Corporation was to organize and manage affiliated investment companies and to acquire initially a substantial part of the equities therein. Mr. Presley, a sponsor and president of the company, testified:[174]

Q. What had you in mind in forming the company?

A. The fundamental principles of this company were No. 1, a management company to manage the capital of an affiliate trust to be formed, and 2, the investment of capital in the junior securities of the affiliates to come. In other words, it was to be a holding and management company.

Practically the entire capital of National Investors Corporation, by September 1929, was invested in the common stocks and rights to buy common stocks of its three affiliated companies, which had a combined capital of $48,000,000.[175] National Investors Corporation secured 33⅓% of the common stock and 200,000 option warrants of Second National Investors Corporation for a contribution of $1,000,000, a sum which amounted to only 9.43% of the total investment in Second National Investors Corporation.[176] Inasmuch as 81% of the initial capital of Second National Investors Corporation was represented by preferred stocks, while some 91% of the capital of National Investors Corporation itself consisted of 5½% preferred stock, the extraordinary leverage position of National Investors Corporation common stock (at $10 per share) in a total amount of $400,000 for the initial 40,000 shares, is very striking. At the top of the highly pyramided structure were the 160,000 National Investors Corporation purchase warrants, of which the organizers received 100,000.[177] These warrants were virtually options upon options,[178] and, in the event that the enterprise exhibited any success at all, the warrants were geared to obtain an extraordinary market value, which they actually did.[179]

The capital structure of Third National Investors Corporation and Fourth National Investors Corporation contained no senior securities.[180] These companies were capitalized with common stock and purchase warrants for common stock.[181] The investments of Third National Investors Corporation and Fourth National Investors Corporation (as well as of Second National Investors Corporation) were almost entirely in common stocks which participated in the soaring securities market of 1929, thus enhancing in a very short period the market value of National Investors Corporation's holdings of purchase warrants of Third National Investors Corporation and Fourth National Investors Corporation.[182]

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[174] Public Examination, National Investors Corporation, at 4271.

[175] Id., at 4393 and the reply to the Commission's questionnaire for National Investors Corporation, Pt. I, Annual Report, 1929.

[176] Public Examination, National Investors Corporation, at 4277 and 4279.

[177] Id., at 4263–4.

[178] Id., at 4348.

[179] Id., at 4348–9.

[180] Id., at 4296 and 4304.

[181] Id., at 4299, 4301, and 4304.

[182] Reply to the Commission's questionnaire for National Investors Corporation, Pt. I, Annual Report, 1929.

The market value of the investment of National Investors Corporation in its three affiliated companies, by the middle of September 1929, had reached a figure of approximately $25,500,000.[183] Adding to this figure about $1,500,000 in cash and miscellaneous holdings possessed by National Investors Corporation brings the total net assets of National Investors Corporation to about $27,000,000.[184] Of these assets, about $22,600,000 were applicable to the equity interests in National Investors Corporation or an asset value of $565 per share for each of the original 40,000 shares (sold at $10 per share in allotment units), before the exercise of purchase warrants. Of course, some of the warrants had been exercised by that time, thus substantially diluting the equity. Nevertheless, on the assumption that by September 15, 1929, approximately 45,000 additional shares had been issued on the exercise of warrants (64,822 issued by October 8, 1929) each of the outstanding 85,000 shares of common stock still had an asset value of approximately $265.

Thus, while the prospects inherent in the leverage structure of National Investors Corporation and of Second National Investors Corporation and in the warrants of the affiliates held by National Investors Corporation, contributed to the rapid rise in the market price of National Investors Corporation common, the fact that the sponsors could point to the actual rise in the asset value of National Investors Corporation common (which had resulted from the holding by National Investors Corporation of the common stock and warrants of the affiliates), was an even more potent factor. It should, moreover, be noted that the sponsors of National Investors Corporation were not content to leave the rise in the market value of the stock and warrants of the affiliated companies to the current enthusiasm for investment company stock; Guardian Detroit Company, Inc. operated a bankers' pool or trading account in the common stock of Second, Third, and Fourth National Investors Corporation.[185] The pool in the stocks of the affiliated companies had a

[183] See the following table:

Shares of affiliates owned by National Investors Corporation	Cost and date of purchase	Percent of total	Market value Sept. 1929
Second National Investors Corporation, Nov. 26, 1928: [a]			
100,000 common	$1,000,000	33⅓	$6,000,000
200,000 warrants		100	7,000,000
Third National Investors Corporation, Mar. 22, 1929:			
20,000 common	1,000,000	9	1,650,000
101,200 warrants [b]		80	2,277,000
Fourth National Investors Corporation: [a]			
685,000 warrants	[c] 2,187,500	68.5	8,562,500
Total	4,187,500	------	25,489,500

[a] Reply to the Commission's questionnaire for National Investors Corporation, Pt. III, Table 2 and Pt. I, Annual Report, 1929.

[b] Of the 130,000 warrants received, 28,800 warrants were surrendered to dealers to facilitate the sale of the shares (Public Examination, National Investors Corporation, at 4302).

[c] Net cost of the 750,000 warrants purchased for $3,000,000 of which 65,000 were sold at $12.50 each, or a total of $812,500. The remaining warrants owned are valued at cost, less this amount, and at market at $12.50 each (Public Examination, National Investors Corporation, at 4318 and 4321).

[184] Reply to the Commission's questionnaire for National Investors Corporation, Pt. I, Annual Report, 1929.

[185] Public Examination, National Investors Corporation, Commission's Exhibits Nos. 433 and 434.

double importance, in that it not only succeeded in advancing the market prices of the affiliates well above their net asset value but also provided a foundation for the successful operations of the other pool in National Investors Corporation common stock, thus constituting, in a sense, one pool operation pyramided upon another pool operation.

As has been observed above, by September 15, 1929 the assets of National Investors Corporation had risen from an initial investment of $4,400,000 to approximately $27,000,000, due to the increase in the market price of securities of affiliates held by National Investors Corporation.[186] The combination of the several elements previously noted, to wit, the leverage factor in National Investors Corporation and in Second National Investors Corporation, the holding of affiliate stock, the superimposition of one pool operation on another, resulted in a total market value for the stock and warrants of National Investors Corporation greatly surpassing even the swollen asset value of National Investors Corporation.[187] In the middle of September 1929, the market valuation of the stocks and warrants of National Investors Corporation reached the grand total of approximately $78,750,000,[188] about three times the net asset value of National Investors Corporation and about 18 times the initial capital of $4,400,000 paid in 11 months previously.

The basic device in the National Investors Corporation group structure was the complex capital set-up of the company by means of which the sponsor, through a comparatively small investment, acquired the power to control the company, to create and control additional companies, and to secure the right to the major share of prospective equity profits.

It must be noted that as rapid as may be the ascent, under favorable circumstances, of the market prices of equity stocks in a complex capital structure,[189] at least as rapid will be the descent of these equity stocks, when the purchasing public reaches the end of its optimism. Before such time, however, the sponsors in many instances have disposed of a significant portion of their holdings to an eager public at large profits. Subsequent to 1929, the common stock of National Investors Corporation experienced a precipitous decline in its asset and market values. From the end of 1930 to the close of 1934, the common stock had no asset value whatsoever.[190] As of December 31, 1935 its asset value was nominal, amounting to

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[186] See supra.

[187] See note 188.

[188] See the following:

40,000 common shares, at 391¾	$15,670,000
40,000 preferred shares, at 101	4,040,000
Total	19,710,000
160,000 warrants	57,680,000
Grand total (minimum)	77,390,000
Estimated grand total	[a] 78,750,000

[a] Total market valuation increased by about $1,350,000, as about 45,000 warrants had been exercised and converted into common shares which sold at a higher price than the warrants.

[189] Preference stocks, for the purposes of this chapter, are comprehended within the term "senior securities," as distinguished from "equity securities." See discussion supra, p. 1576, and note 71.

[190] Reply to the Commission's questionnaire for National Investors Corporation, Pt. IV (Item 28).

but 21 cents per share.[191] By December 31, 1932 the market value of this stock was $3⅜ per share. The year-ends of 1933, 1934, and 1935 disclosed even further declines in market price, to wit, $2½, $1¼, and $2 per share, respectively.[192] The warrants, the majority of which had been given to the insiders free of any cost and which had experienced so phenomenal a rise in 1929, followed the market decline of the common stock. These warrants sold as low as $⅜ in 1932 and $13/16 at the end of 1935.[193]

Mr. Presley, president of National Investors Corporation, testified to the dangers implicit in this type of capital structure:[194]

Q. While that type of structure, assuming that I am right that it contributed to a large extent in permitting a comparatively small investment, because no matter how large Guardian's investment was in National Investors, it was very small compared to the total investment that the public made in the four companies——

A. That is right.

Q. While there may have been certain advantages in that type of corporate structure, from the standpoint of the organizing group, looking toward retention of control, have you or have you not found that there are certain weaknesses in that situation, perhaps from the standpoint of somebody else getting that same control?

A. A very great weakness.

Q. Why do you say that, Mr. Presley?

A. The weakness is inherent in almost any holding company, whether it is in the investment trust field, or in the utility field, or industrial field, of control of a large amount of money, or numerous companies, through the so-called "B-stock set-up" so that a small amount of money initially is capable of controlling a tremendous amount of money through subsidiaries in the case of investment trusts or acquisitions. But the greatest danger lies in the collapse of shares of that Type B type control stock[195] in periods of depression, and where, as in the case of Guardian Detroit Company's position, a large block became available, at a very low price in relation to the value of the assets of the affiliated companies.

(4) AMERICAN, BRITISH & CONTINENTAL CORPORATION

Investment companies apparently have been regarded by financiers as an excellent device for obtaining the use of other people's money. Several illustrations have been cited of the very common practice of devising complex capital structures which will divorce management power from substantial investment in the company, and create a great disparity between the right to potential profit and the proportion of capital contributed. Nevertheless, sponsors are sometimes

[191] Ibid.

[192] Ibid. Due to a common stock split-up of 6-for-1 in October 1929, the price of the common stock on the basis of the old would therefore be 15, 7½, and 12, respectively.

[193] In October 1929, when the common stock was split 6-for-1, the warrants formerly exercisable to purchase 1½ shares of common stock became exercisable to purchase 9 shares of new common stock only (Reply to the Commission's questionnaire for National Investors Corporation, Pt. V, Item 54a, Table 16).

[194] Public Examination, National Investors Corporation, at 4513–14.

[195] Mr. Presley patently used the phrase "B stock type of set-up" to cover any capital structure situation wherein a small investment controls a large fund. None of Mr. Presley's companies actually used the literal B stock type of set-up.

constrained to make a sizable investment in the company initially. Under such circumstances, the sponsors, wielding control, are in a position to recapitalize the company subsequently on a basis which will permit the withdrawal of the bulk of their investment without disturbing their position of control or affecting their share in potential profits. An apposite example is the case of American, British & Continental Corporation.

American, British & Continental Corporation was organized under the laws of the State of Delaware on November 18, 1926.[196] The company was sponsored jointly by the investment banking and brokerage house of Blyth, Witter & Co. (firm name now Blyth & Co., Inc.), and J. Henry Schroder Banking Corporation, in association with 10 European banking houses.[197]

The capital structure of the corporation consisted of 100,000 shares of $6 cumulative first preferred stock, 40,000 shares of $6 cumulative second prefered stock, and 400,000 shares of common stock.[198] The public subscribed to the entire issue of 100,000 first preferred stock allotment certificates, each of which represented one share of first preferred stock and one share of common stock,[199] for a total contribution of $10,000,000.[200] The sponsors and their European associates, at a cost of $4,000,000, acquired the 40,000 shares of second preferred stock and 300,000 shares of common stock, by subscribing to 40,000 units at $100 per unit, each unit consisting of one share of second preferred stock and 7½ shares of common stock.[201] The management common stock was immediately deposited in a voting trust.[202]

The articles of incorporation vested exclusive voting power, except for the rights of the preferred stocks contingent upon default, in the common stock. As the prior asset claims of the senior securities in the event of liquidation totaled $14,000,000, or as much as the gross contribution to the capital of the company, the common stock, at inception, had no asset value whatsoever. The common stock, therefore, may properly be considered as having been issued as a bonus—100,000 shares or 25% thereof to the public with the first preferred stock, and 300,000 shares or 75% thereof to the sponsors with the second preferred stock. Thus, the sponsors, by an investment in second preferred stock of 28.6% of the contributed capital, secured 75% of the voting power and the right to 75% of the surplus profits, while the public, for a contribution on behalf of the first preferred stock of 71.4% of the total contribution, received 25% of the voting power and the right to 25% of the surplus profits.

In February 1928, a little more than a year after American, British & Continental Corporation began operations, the company was compelled to raise additional funds through the issuance of a de-

[196] Public Examination, American, British & Continental Corporation, Commission's Exhibits Nos. 444–6.

[197] Id., at 4596, and Commission's Exhibit No. 450.

[198] Id., Commission's Exhibit No. 444.

[199] Id., Commission's Exhibit No. 446.

[200] Net proceeds to the corporation were $9,600,000, $400,000 being retained by the sponsors as commissions on distribution.

[201] Op. cit. supra, note 194, Commission's Exhibit No. 446.

[202] Id., Commission's Exhibit No. 448.

benture flotation in order to reduce its indebtedness to the banks,[203] and $5,000,000 of 5% $100 face value gold debentures were sold to the public at $92 net to the corporation.[204] This additional public contribution of $4,600,000 to the capital reduced the proportionate contribution of the sponsors to 21.5%.

At the end of 1928, after the public had invested over $14,000,000 in American, British & Continental Corporation, the bankers proceeded to recapitalize the company so as to reduce the amount of their own investment, and yet retain their influence and rights in the company. As the sponsors held 75% of the common stock and all of the issue of second preferred stock, they had no difficulty in having the plan of recapitalization and the necessary amendments of the charter adopted.[205] Pursuant to the plan, the bankers converted their 40,000 shares of second preferred stock into 200,000 shares of common stock.[206] A public offering of 120,000 shares of common stock was then made, the 120,000 shares so offered being provided by the bankers out of the 200,000 shares which they had received on the conversion of their second preferred stock.[207] The sponsors realized $2,098,500 through the sale of the 120,000 shares of common stock.[208] The sponsors thus reduced their original investment of $4,000,000 in the company by more than half, and at the same time retained control of the company. Possessing 500,000 shares of the 600,000 shares of common stock outstanding after the conversion of the second preferred stock, the bankers had sold 120,000 of those shares. The 380,000 shares of common stock retained by them represented 63.3% of the voting power of the company and the right to the same percentage of prospective surplus profits.[209]

The refinancing, by means of which the sponsors were enabled to reduce their risk by more than one-half and at the same time retain control of the company's affairs, also afforded them the opportunity to realize substantial profits over the original cost to them of the securities sold. Gerald F. Beal, president of J. Henry Schroder Banking Corporation, testified[210] that the sponsors had originally

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[203] Id., Commission's Exhibit No. 450.

[204] Id., at 4626, and Commission's Exhibits Nos. 450 and 451.

[205] Approval of two-thirds of the common stock and of a majority of the second preferred stock was necessary (id., Commission's Exhibit No. 444 (C. & S.)).

[206] Op. cit. supra, note 194, at 4655–6.

[207] The European banks had deposited 81,000 shares of common at $17 per share with a buying group composed solely of Blyth, Witter & Co. and J. Henry Schroder Banking Corporation. The buying group, i. e., the American bankers, then turned over to a selling group 120,000 shares of common at $18.50 per share. These 120,000 shares consisting of the 81,000 shares deposited by the European concerns plus 39,000 shares deposited by Blyth, Witter & Co. and J. Henry Schroder Banking Corporation, came out of the 200,000 shares of new common resulting from the conversion of the bankers' holding of second preferred stock. Thus, Blyth, Witter & Co. and J. Henry Schroder Banking Corporation received $18.50 per share for their 39,000 shares of new common and the Europeans received $17 per share for the balance. The selling group, in turn, sold to the public at $20 per share the entire 120,000 shares received from the buying group, plus an additional 5,000 shares supplied by Blyth, Witter & Co. out of other holdings (id., at 4659–61, 4665, 4672).

[208] Op. cit. supra, note 196, at 4673.

[209] The sponsors sold the 120,000 shares at 2½ times the cost thereof to them. They had received 500,000 shares at a cost of $4,000,000, or $8 per share, and sold 120,000 shares at $20 per share. The common stock at this time had a net asset value of $8.41 per share.

[210] Public Examination, American, British & Continental Corporation, at 4797.

invested $4,000,000 in the issue of second preferred stock so that the first risk of loss would fall upon them rather than upon the public:

Q. Do you recall why it was that the bankers determined to put their investment in the form of second preferred stock; what was the thought there?

A. The thought was this: We felt in the first place that if we were going to issue securities to the public, that there should be a cushion ahead of them. We determined that we would make that cushion $4,000,000, which the sponsors would have to lose before the public lost anything.

Many investors undoubtedly became stockholders in American, British & Continental Corporation in reliance upon the apparent readiness of the sponsors to share the first risk with the public. As has been noted, the sponsors, within two years after the formation of the company, shifted more than 50% of their risk to the public and realized a profit in so doing of $1,138,500.[211]

The stock for which the public paid $20 per share at the end of 1928 fell precipitously in asset value and in market price within a year. By the end of 1930, the stock had no asset value, and through the period 1930–1935 it never regained an asset value.[212] In 1932 this common stock had a market quotation as low as $1/16 per share, with a slight recovery at the year ends of 1934 and 1935 when it was quoted at $3/8 and $1/4, respectively. On the basis of the market quotation at the end of 1935, the individual who had purchased a share for $20 was faced with an unrealized loss of $19.75, while taken as a group the purchasers of these 120,000 shares were faced with a loss in market value totaling $2,370,000.[213]

(5) SHAWMUT BANK INVESTMENT TRUST[214]

The capital set-up devised by The National Shawmut Bank of Boston, Massachusetts, and The Shawmut Corporation, its security affiliate, for the Shawmut Bank Investment Trust, an unrestricted management investment company created under a declaration of trust,[215] was somewhat similar to that of United States & Foreign Securities Corporation. The sponsor secured 50% of the equity rights in a company capitalized at $6,000,000 through an investment of $1,040,000 in a junior debenture issue.[216] Control was not an

[211] The sponsors had originally contributed $100 per unit of one share of second preferred stock and 7½ shares of common stock, receiving in all 40,000 shares of preferred stock and 300,000 shares of common stock. By the plan of recapitalization they now received 5 shares of common stock for each share of preferred stock, thus obtaining 12½ shares of common stock for each $100 contributed, an average cost of $8 per share. They disposed of 120,000 shares of common stock for $2,098,500—thereby realizing a profit of $1,138,500.

[212] Reply to the Commission's questionnaire for American, British & Continental Corporation, Pt. I (Annual Reports).

[213] It will be recalled that the purchasers of this common stock suffered a complete loss in asset value. See supra. The first preferred stock was "under water" over the period 1930–1935. (See supra, pp. 1570–1.)

[214] See also infra, pp. 1597–1641.

[215] Reply to the Commission's questionnaire for Shawmut Bank Investment Trust, Pt. IV, Item 19.

[216] Public Examination, Shawmut Bank Investment Trust, et al., at 3295 and Commission's Exhibit No. 354 (pp. 13–14).

objective of the form of capitalization inasmuch as this investment company was a Massachusetts trust, the shareholders in which have no effective voting rights, the management of the company resting in the hands of self-perpetuating trustees.[217] The policies of the trust were controlled by The National Shawmut Bank by reason of the fact that directors and officers of the bank were the trustees of the investment company.[218]

The trust, upon organization, sold $5,000,000 of senior debentures to the public, $2,500,000 of which, maturing March 1, 1942, carried an interest rate of 4½% per annum and the other $2,500,000, maturing March 1, 1952, carried an interest rate of 5% per annum.[219] An issue of $1,000,000 par value "Junior notes" maturing March 1, 1952, and carrying 6% interest per annum was purchased by The National Shawmut Bank, the sponsor, for $1,040,000.[220] The $5,000,000 of senior debentures were accompanied by stock warrants for 37,500 shares of common stock, as were the $1,000,000 of junior notes.[221] An equal number of common shares was thus set aside, without additional cost, for the whole class of senior debenture holders and for the class of junior note holders.[222] The sponsor, supplying one-sixth of the capital, became entitled to 50% of the surplus profits of the company.

The common stock at inception had no asset value.[223] The net proceeds to the company from the sale of the securities totaled $5,990,000, slightly less than the par value of the debentures, due to the fact that the company had paid a small underwriting fee to The Shawmut Corporation,[224] a security affiliate of the bank. All appreciation in the assets of the company over the par value of the debentures and notes (and interest charges on debentures) would accrue to the common stock, 50% of which was owned by the sponsor.[225]

As of December 31, 1929, the assets of the investment company had increased to about $8,000,000.[226] The common stock had thus acquired an equity of about $2,000,000. The $1,000,000 of "Junior notes" originally purchased by the sponsor were fully covered, and the sponsor had an unrealized profit to the extent of approximately another million dollars, in the accrual of asset value to its equity stock. The 37,500 shares of common stock received by the sponsor as a bonus had acquired an asset value of $25.99 per share.[227]

While the equity profits during the early prosperous period accrued entirely to the common stock, the absence of any safeguards for the debentures left them completely exposed at the termination of the

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[217] Id., Commission's Exhibit No. 354 (p. 10).

[218] Reply to the Commission's questionnaire for Shawmut Bank Investment Trust, Pt. IV, Item 21, and op. cit. supra, note 216, at 3307.

[219] Op. cit. supra, note 216.

[220] Ibid.

[221] Id., at 3303–4.

[222] Id., at 3304.

[223] Op. cit. supra, note 216, at 3297–8, 3292 and Commission's Exhibit No. 354.

[224] Id., at 3295.

[225] See supra, p. 1618.

[226] Reply to the Commission's questionnaire for Shawmut Bank Investment Trust, Pt. II,

[227] Reply to the Commission's questionnaire for Shawmust Bank Investment Trust. Pt. IV, Table 7, Sec. IV.

inflated market. In November 1931 the senior debentures were "under water" and the "Junior notes" had no asset value at all.[228]

b. Illustrations of the Class B Common Stock Form of Complex Capital Structure

Prior to 1927, promoters and sponsors often secured the advantages flowing from a complex capital structure by organizing investment companies with an issue or issues of debentures and/or preferred stock in addition to a single variety of common stock. After 1927 "common stock," carrying the suggestion of a share in the potential surplus profits, was discovered to be meeting with increasing popular favor. In addition, the weakness of the senior security of the investment company in respect to assurance of safety, possibility of profit, and participation in management, began to be noted by some security purchasers. Hence, a variation of complex capital structure, different in form from the conventional bond, preferred plus common stock type of set-up, began to be utilized by sponsors of investment companies. The innovation in this new type of set-up was the creation of several classes of "common stock." One class, usually called Class A common stock, was intended primarily for distribution to the public, and the other was designed for the sponsor. The latter class, commonly called Class B common stock, was represented by no contribution or a very small contribution to the capital investment—yet carried the major part of the voting power in the company. While in some companies the Class B common stock was not granted the whole of the surplus profits, it generally held the right to a proportion of the equity profits surpassing its proportion of capital contribution. On the other hand, the Class A common stock issued for public distribution, which brought the major contribution to the capital of the company, was awarded little voting power and was generally underprivileged in respect to surplus profits. To compensate for the subordination of the Class A common stock in these respects, this class was generally granted a limited fixed priority over the Class B common stock in the distribution of dividends.

The general effect of this type of set-up was to secure to the sponsor who held the Class B common shares the advantages of the common-stock holder in the conventional complex structure while relegating the investor who held the Class A stock to a status resembling that of the senior security holder in the conventional complex structure company.

In numerous instances such companies issued bonds and/or preferred stocks in addition to classified common stocks. In such cases the position of the Class A common stockholder was particularly weak—he was accorded neither the possibility of a substantial share of the equity profits—implied by the designation "common stock"—nor the early priority rights granted to the bonds and preferred stock.

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[228] The common stock fell from an asset value of $25.99 on December 31, 1929, to $5.22 on December 31, 1930. From 1931 through 1935 it had no asset value. The notes had no asset coverage from 1931 through 1934 and were "under water" on December 31, 1935. The senior debentures did not regain full asset coverage until the end of 1935 (Reply to the Commission's questionnaire for Shawmut Bank Investment Trust, Pt. IV, Item 28). See discussion of absence of safeguards for these debentures, infra, pp. 1597–1641.

Several examples will be presented wherein the sponsors, by setting up a capital structure containing Class A common stock and Class B common stock, secured the advantages which other sponsors attained through the bonds and/or preferred stock structural pattern.

(1) ITALIAN SUPERPOWER CORPORATION

Italian Superpower Corporation was organized on January 19, 1928, in Delaware,[229] by Bonbright & Company, Incorporated and Field, Glore & Co.[230] representing American interests, and Banca Commerciale Italiana of Milan, Italy, the largest Italian commercial and investment bank, representing Italian interests.[231]

During the first year of its existence, the company issued 35-year 6% debentures; $6 cumulative preferred stock; Class A common stock and Class B common stock in exchange for Italian securities of an aggregate market value of $31,957,902 (which constituted its original portofolio) and $3,000,000 contributed in cash.[232]

The agreement between the sponsors, dated December 5, 1927, contemplated the sale of the Italian securities by the sponsors to the investment company for which the company would pay the sponsors two-thirds in cash and one-third in preferred stock of the company. The necessary cash was to be raised by the resale to the American public of the company's debentures. The equity stock was to be issued as a bonus, roughly half to the American sponsors and half to the Italian sponsors.[233]

On January 31, 1928, the sponsors turned over to the newly formed company Italian securities with a market value of $31,957,902.25.[234] The company issued to the sponsors in exchange not only 6% debentures and 6% cumulative preferred stock but also 850,000 shares of Class A common stock and 150,000 shares of Class B common stock.[235] The original agreement necessarily contemplated that there would be no equity assets in back of the common stock, as it provided that the sponsors be fully reimbursed for the securities transferred to the company by the debentures and preferred stock issued. As the company was to issue debentures and preferred stock equal in dollar value to the price established for the assets, there would be left no equity for the common stock.

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229 Reply to the Commission's questionnaire for Italian Superpower Corporation, Pt. I, Items (d) (e).
Exhibit A.

230 Public Examination, Italian Superpower Corporation, at 7596.

231 Op. cit. supra, note 229, Pt. I, Item 5, Exhibit C (1) and Pt. IV, Item 20.

232 Id., Pt. V, Item 41, and Pt. VII, Table 32 (note). Subsequently, on July 1, 1929, the company increased the amount of its funded debt by $2,000,000 through the sale of $4,000,000 of 35-year 6% debentures (with option warrants attached), only $2,000,000 of which constituted a new issue, the balance consisting of previously issued debentures which had been reacquired by the company (id., Pt. V, Item 41, and Pt. I, Exhibit F (2)).

233 Op. cit. supra, note 230, at 7669, and the reply to the Commission's questionnaire for Italian Superpower Corporation, Pt. I, Exhibit C (1).

234 The agreement of December 5, 1927 (reply to the Commission's questionnaire for Italian Superpower Corporation, Pt. I, Exhibit C (2)), stated that the market value of the securities to be transferred by the sponsors was $28,251,515.96 (Public Examination, Italian Superpower Corporation, at 7669). The difference between that amount and $31,957,902.25 is explained by an increase in market value between December 5, 1927, and January 31, 1928.

235 Reply to the Commission's questionnaire for Italian Superpower Corporation, Pt. I, Exhibit C (5), p. 2, and Pt. VII, Table 32 (note).

The company issued to the sponsors, in exchange for the securities transferred to it, its own securities in the following proportions:[236]

Total issued to sponsors in exchange for Italian securities	Issued to Bonbright & Co., Inc. and Field, Glore & Co.	Banca Commerciale Italiana, Milan	A. P. Talliaferro	C. W. Street
$20,250,000—6% debentures, 1963	$20,250,000			
94,172 shs. $6 preferred	10,750 shs.	83,253 shs.	84 shs.	85 shs.
850,000 shs. Class A common	355,710 shs.	437,467 shs.	28,361 shs.	28,462 shs.
75,000 shs. Class B common first series		75,000 shs.		
75,000 shs. Class B common 2d series	75,000 shs.			

Bonbright & Company, Incorporated and Field, Glore & Co., Inc., the principal American sponsors, undertook to transform the debentures into cash so that the various sponsors might receive the two-thirds in cash which the original agreement contemplated. The American bankers offered to the public units at $1,000, each unit consisting of a $1,000 debenture, five shares of Class A common stock, and an option warrant issued by Bankers Trust Company, as depositary, which entitled the holder to purchase 10 shares of Class A common stock of the corporation up to January 1, 1938, at prices progressively increasing from $10.00 to $20.00 per share. These option warrants represented a right to purchase shares of Class A common stock, originally acquired by the American sponsors which were deposited with Bankers Trust Company.[237]

By this method of disposition, the American bankers received from the public $20,250,000, for which they transferred to the public the issue of $20,250,000 6% debentures, 101,250 shares of Class A common stock, and warrants to purchase 202,500 shares of Class A common stock.[238] The American sponsors apparently distributed the cash to the Italian and American sponsors in the proportion in which each had contributed Italian securities to the company's portfolio.

The Class A common stock, which was given as a bonus with the bonds sold to the public, was contributed by the American sponsors from the shares of Class A common stock which they had themselves received as a form of bonus from the company.[239] The original plan had contemplated that the entire block of the Class A common stock received by the American bankers should go as a bonus with the debentures offered to the American public.[240] However, by the time the debentures were actually offered to the public, the stock markets in Italy and the investment market in New York had gone up so that the American sponsors considered the donation of their entire Class A stock to the purchasers of the debentures excessive, and therefore

[236] The figures are derived from the reply to the Commission's questionnaire for Italian Superpower Corporation, Pt. I (Exhibit C–5) and Pt. II (Exhibit A, Schedules 16, 18, and 19) and from the Public Examination, Italian Superpower Corporation, at 7673–5.

[237] Id., Pt. I, Exhibit F (1). These rights to purchase the Class A stock were designated "reversionary certificates."

[238] Op. cit. supra, note 230, at 7673–4.

[239] Id., at 7660–3 and 7670.

[240] Id., at 7662.

granted outright to the public only 101,250 shares of the Class A common stock, retaining the remainder for themselves subject to the exercise by the public of the options accompanying the debentures.[241]

Concurrently with the distribution of securities described above, the corporation offered 30,000 shares of 6% preferred stock and 120,000 shares of Class A common stock to interests affiliated with the sponsors, for $3,000,000 cash.[242] This cash was to provide a working capital. As the par value of the preferred was $100, the 120,000 shares of the Class A common stock were offered as a bonus to these interests.

It should be noted that the Class B common stock was held entirely by the sponsors, 75,000 shares by Bonbright & Company, Incorporated and Field, Glore & Co., and 75,000 shares by Banca Commerciale Italiana.[243] The Class B common stock was the only security entitled to vote. In all other respects, the Class A common stock and the Class B common stock were identical.[244] Through their ownership of the Class B stock, which had a stated value of 10 cents per share and for which they had contributed no consideration to the company, the sponsors had complete control of the corporation.

Of the Class A common stock there were issued in all 970,000 shares,[245] 850,000 shares as a bonus to the organizers and 120,000 shares as a bonus with the preferred stock sold to the interests affiliated with the sponsors.[246] It will be recalled that the American sponsors parted with 101,250 of these shares to accompany the debentures. The remaining Class A shares were retained by the sponsors and the interests associated with them. Since the Class A stock and Class B stock were equally entitled to share in the equity and surplus profits, the equity interests of the public consisted of an ownership of 101,250 equity shares out of a total of 1,120,000 equity shares (Class A and Class B), or 9%.

Hence, it will be noted that the public, which had put $20,250,000 into the company through the purchase of debentures, held less than 10% of the equity securities and had no voice at all in the management, while the insiders held over 90% of the equity stock and 100% of the voting securities.

The amount that the sponsors and their affiliated interests actually invested in the company may readily be calculated. The original sponsors, which had transferred to the company Italian securities of a market value of $31,957,902.25,[247] received payment of two-thirds of the value in cash.[248] The remaining third of the value, approximately $10,000,000, represented their investment in the company.[249] The interests affiliated with the sponsors had contributed $3,000,000 in cash for 30,000 shares of 6% preferred stock.[250] In all, the sponsor

[241] Id., at 7662–3.

[242] Reply to the Commission's questionnaire for Italian Superpower Corporation, Pt. I, Exhibit C (3), and Pt. II, Exhibit A, Schedule 18.

[243] Id., Pt. I, Exhibit C.

[244] Op. cit. supra, note 230, Commission's Exhibit No. 701 (note under "Capitalization").

[245] Id., Commission's Exhibit No. 701.

[246] Op. cit. supra, note 242.

[247] Id., Pt. VII, Table 32 (note).

[248] Id., Pt. I, Exhibit C (1) and op. cit. supra, note 182, at 7669.

[249] Op. cit. supra, note 230, at 7667–9.

[250] Op. cit. supra, note 242, Pt. V, Item 41.

interests contributed approximately $13,000,000 out of a total contribution of $34,957,902.25. As noted above, they secured 100% control of the company and the right to receive in excess of 90% of the profits. In addition, of course, their investment was represented by 6% cumulated preferred stock of a face value equivalent to their investment.[251]

It should be recalled that the sponsors received Class A stock and Class B stock as a bonus. The American sponsors had granted options on some 202,500 shares of their Class A stock to the purchasers of the debenture units, retaining what were termed "reversionary certificates" in that Class A stock, namely, the right to the exercise price or the unencumbered return of the stock from the trustee if the options were not exercised by a fixed date. In January 1929 Bonbright & Company, Inc. and Field, Glore & Co. sold their Class B stock and the major part of their interest in the reversionary certificates to American Superpower Corporation, an investment-holding company which Bonbright & Company, Inc. had formed in 1923,[252] in exchange for Class A stock of American Superpower Corporation of an approximate value of $2,900,000.[253] Bonbright & Company, Incorporated, immediately disposed of its shares of the American Superpower Corporation Class A stock for $1,272,-650.[254] Field, Glore & Co. appears to have realized at least an equal amount in the disposal of its Class A stock of American Superpower Corporation.[255] These sums must be considered clear profit to the American bankers, inasmuch as both the reversionary certificates and the Class B stock which they turned over to American Superpower Corporation had been received by them without cost.[256]

American Superpower Corporation, on the other hand, ultimately sustained a loss on the transaction of over $2,500,000. That corporation sold a small part of the reversionary certificates in 1929 and 1930 at a small profit and the balance of the reversionary certificates and the Class A stock in 1936 to Atlas Corporation for a total of $213,990.[257] Thus the banking sponsors of Italian Superpower Corporation turned their bonus stock into a cash profit of more than $2,500,000, while a loss of approximately the same amount was sustained by American Superpower Corporation, an investment company under the same sponsorship as Italian Superpower Corporation.

(2) STERLING SECURITIES CORPORATION

Sterling Securities Corporation is an example of the advantages accruing to sponsors through their authority over the form and manner of the capitalization of the investment company. In this company management contributed less than $150,000 [258] and controlled a fund,

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[251] The details concerning the substantial profits which Bonbright & Company, Inc., and Field, Glore & Co. subsequently made through the sale of their Class B common stock are related in Ch. III of this part of the report, pp. 928–35.

[252] Public Examination, American Superpower Corporation, at 9299.

[253] Public Examination, Italian Superpower Corporation, at 7723.

[254] Op. cit. supra, note 252, at 9361.

[255] Id., at 9360.

[256] Id., at 9361.

[257] Op. cit. supra, note 230, Commission's Exhibit No. 704; Op. cit. supra, note 252, at 9379–83.

[258] Public Examination, Sterling Securities Corporation, at 14662 and 14710–1.

collected from the public, of more than $32,000,000. By a two-class preferred and a two-class common stock set-up they constructed an outstandingly top-heavy leverage structure. By a well-planned parceling out of rights and privileges to the various types of securities, they contrived to secure for the management Class B common stock, acquired by them at 50 cents a share,[259] the right to 25% of all the corporation's profits. and appreciation in assets above the payment of the limited fixed claims of the senior securities.[260] They allotted to the Class B stock special comulative voting rights,[261] until compelled to relinquish them at the insistence of the New York Stock Exchange.[262] Upon the termination of the period of security-market inflation, the sponsors, due to the special powers vested initially in the management stock. were able to secede from the company and secure large premiums for the transfer of control to other interests.[263]

Sterling Securities Corporation was incorporated in Delaware on February 18, 1928.[264] Its formation was the result primarily of the efforts of Edward B. Twombly, Sterling Pile,[265] and Walter R. Wolf.[266] Mr. Twombly was a member of the law firm of Putney, Twombly and Hall, of New York City, and was then counsel for and a director of Insuranshares Corporation of New York,[267] a securities distribution organization of which Sterling Pile was president.[268] Walter R. Wolf was the assistant to the president of The Farmers' Loan and Trust Company,[269] which acted as trustee and custodian of portfolio of Insuranshares Certificates, Inc., a limited-management investment company [270] for which Insuranshares Corporation of New York served as the distributing organization.[271] Management of the portfolio was entrusted to the investment counsel firm of Scudder, Stevens & Clark.[272]

The certificate of incorporation of Sterling Securities Corporation provided for the issuance of four classes of stock, to wit, convertible first preferred stock, preference stock, Class A common stock, and Class B common stock.[273] Through the acquisition of the Class B common stock the management secured its strategic position in the corporation.[274]

On March 3, 1928, the corporation issued 28,333 shares of its Class B common stock to each of the three primary sponsors, Sterling Pile, Walter R. Wolf, and Edward B. Twombly.[275] On the same day

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[259] Id., at 14642–6.

[260] Id., at 14707–10.

[262] Id., at 14659.

[263] Id., at 14726–31.

[264] Reply to the Commission's questionnaire for Sterling Securities Corporation, Pt. I, Item 1 (d) (e), and op. cit. supra, note 258, at 14627–8.

[265] Op. cit. supra, note 258, at 14639.

[266] Id., at 14630, 14632.

[261] Id., at 14648–9.

[267] Id., at 14621–2.

[268] Id., Commission's Exhibit No. 1503.

[269] Id., at 14632, 14634.

[270] Id., at 14626–8 and 14684–6.

[271] Reply to the Commission's questionnaire for Insuranshares Certificates, Inc., Pt. I.

[272] Op. cit. supra, note 258, at 14760 and Commission's Exhibits Nos. 1509 and 1511.

[273] Id., Commission's Exhibit No. 1496.

[274] Id., at 14660.

[275] Id.. at 14666 and 14690.

30,000 shares of the Corporation's Class B common stock were purchased by Insuranshares Corporation of New York; [276] 30,000 shares by Harold A. Fortington,[277] the American financial representative of the Royal Insurance Company of England,[278] who had been selected as a member of the corporation's financial committee; [279] and 30,000 shares by the firm of Scudder, Stevens & Clark,[280] the manager of the corporation.[281] All the sales of the Class B common stock were at 50 cents per share.[282] During 1928 and 1929 a total of 48,298 additional shares of Class B stock were issued at the same price of 50 cents per share to other directors and officers of the corporation.[283] Thus a total of 223,297 shares of the Class B common stock of Sterling Securities Corporation, more than a majority of the number of such shares authorized by the corporation charter,[284] were issued to the above-named organizers and sponsors of the corporation for a total consideration of $111,648.50.[285]

During the first period of distribution another block of 50,000 shares of Class B common stock was issued.[286] This constituted part of a 50,000-unit public offering.[287] The Class B common stock contained in these units constituted the only Class B common stock sold to the public.

At the end of the first distribution 273,297 shares of Class B common stock had been issued for a contribution of $136,648.50 to the company's capital. By far the greater part of the contribution to the capital of the company came from the sale of the preference stock and the Class A common stock to the public in this period.

Early in March 1928 Sterling Securities Corporation had sold to the public 50,000 units, each consisting of five shares of preference stock, five shares of Class A common stock, and one share of Class B common stock, at a price of $160.50 per unit.[288] As noted above, the 50,000 Class B shares contained in these units constituted the only Class B common stock distributed to the public. The net proceeds to the corporation from the sale of these units totaled $8,025,000—$8,000,000 in payment for the preference stock and the Class A common stock and $25,000 in payment for the 50,000 shares of Class B stock.[289]

In May 1928, Insuranshares Corporation of New York, in the capacity of exclusive selling agent for Sterling Securities Corporation [290] had offered to the public 250,000 units of its securities at $34 per unit, each unit consisting of one share of preference stock and one share of Class A common stock.[291] Sterling Securities Corporation received

[276] Id., at 14666.
[277] Ibid.
[278] Id., at 14631.
[279] Id., at 14692.
[280] Id., at 14666.
[281] Id., at 14692.
[282] Id., at 14642.
[283] Id., Commission's Exhibit No. 2001 (pp. 259–61).
[284] Id., Commission's Exhibit No. 1496.
[285] Id., Commission's Exhibit No. 2001 (pp. 259–60).
[286] Id., at 14653.
[287] Ibid.
[288] Ibid.
[289] Id., at 14654.
[290] Id., at 14655–6 and Commission's Exhibit No. 1497.
[291] Id., at 14654–5.

$8,000,000 net proceeds from the sale of the securities,[292] Insuranshares Corporation receiving gross selling commission of $500,000.[293]

Thus, at the conclusion of this phase of the financing, Sterling Securities Corporation had received for the issuance of 500,000 shares of its preference stock 500,000 shares of its Class A common stock and 273,297 shares of its Class B common stock, a total of $16,136,648.50.[294] Of the total capital contribution to the corporation, only $136,648.50 had been contributed by the holders of the 273,297 shares of the Class B common stock outstanding. Of these 273,297 shares of Class B common stock, the corporation's sponsors, officers, directors, investment managers, and selling agents had acquired a total of 223,297 shares for which they had paid $111,648.50.

A review of the rights and privileges accorded to the various classes of securities by the charter of the corporation will indicate what the sponsors had secured for their investment of approximately $111,000 in the corporation.

The authorized capital structure of the corporation consisted of 500,000 shares of 6% convertible first preferred stock of the par value of $50 per share, entitled on the dissolution of the corporation to a prior preference in assets to the extent of $50 per share and accrued dividends, and convertible within a specified period of time into Class A common stock at a specified ratio.[295] It will be noted that in the first period of distribution no stock of this type had been issued.

The preference stock was entitled to a dividend of 6% per annum, had a par value of $20 and was entitled on dissolution to $20 per share and accrued dividends.[296]

The Class A common stock was without par value and entitled on dissolution, prior to the Class B common stock, to $12 per share.[297]

The Class B common stock was entitled to 25% of the corporate earnings after payment of 6% per annum upon all senior securities.[298]

The first preferred and the preference stock received no voting privileges except upon a default in payment of one year's annual dividends, in which event these stocks acquired one vote per share for all corporate purposes.[299] The Class A common stock and Class B common stock were equally entitled to one vote per share for all corporate purposes,[300] but a significant distinction was made between the rights of the Class A shares and the Class B shares in the election of directors of the corporation. Whereas the Class A stockholder was limited to one vote per share for each director to be elected,[301] the certificate of incorporation provided that each Class B stockholder "is entitled to as many votes as shall equal the number of his shares multiplied by the number of directors to be elected and may cast all of such votes for a single director or may distribute them between the number to be voted for or any two or more of them as he may see fit." [302] Inasmuch

[292] Id., at 14655.
[293] Id., at 14656.
[294] Id., at 14657.
[295] Id., Commission's Exhibit No. 1496.
[296] Ibid.
[297] Ibid.
[298] Id., at 14707–9.
[299] Id., Commission's Exhibit No. 1496.
[300] Ibid.
[301] Ibid.
[302] Id., Commission's Exhibit No. 1496 (3A) (p. 12).

as there were almost half as many shares of Class B stock outstanding as of Class A stock, this cumulative feature assured the holders of the Class B stock of an approximate mathematical minimum of one-third of the directors and, in practice, of a much greater proportion, as the holders of the Class B stock could mass their votes strategically in such a manner as to be most effective.

The Class B stock with a contribution of $136,648.50 (273,297 shares at 50 cents per share) held practical working control of the corporation, in which over $16,000,000 had been invested, and was entitled to 25% of all the surplus profits earned by the company. As has been pointed out above, practically all of this favored class of stock (223,297 shares out of 273,297 shares) had been obtained by the sponsoring interests.

In the latter connection, note should be taken that the sponsors fortified their position in the corporation by a specific provision granting a preemptive right to the Class B stockholders to purchase all future issues of Class B stock, whereas all preemptive right of the other classes of stockholders was eliminated by express charter provisions.[303] A further clause in the charter provided that the consent of at least 75% of the Class B stockholders must be obtained in order to increase the number of Class B shares originally authorized by the charter.[304] To procure a greater cohesiveness among the Class B shares, a voting trust for all the management Class B common stock was created on March 3, 1928.[305] The voting trustees were Walter R. Wolf, Sterling Pile, and Edward B. Twombly.[306] Although the voting trust was by its term to exist for 10 years, it was abrogated on June 25, 1929.[307]

The great advantages afforded to the Class B stock of the corporation in a rising market is well illustrated by the financial condition of the company as at December 31, 1928. The public held 500,000 shares of preference stock and 500,000 shares of Class A common stock for which it had contributed $16,000,000 to the enterprise.[308] The net worth of the corporation on December 31, 1928, was $18,434,261.42,[309] showing a gain of $2,434,261.42 over the total dissolution claims of the preference and Class A stocks ($16,000,000). Of this gain 25%, or $608,565.35, accrued to the Class B stockholders. This represented an increase of more than 360%,[310] upon the contribution of $131,898.50 made to the corporation by the holders of the 263,797 shares of Class B stock then outstanding.[311]

In the course of the first distribution of its securities the corporation had not yet disposed of any of the first convertible preferred stock authorized by the charter. On September 9, 1929, the corporation received net proceeds of $15,000,000 from the sale of 300,000 shares of

[303] Id., at 14650.

[304] Id., Commission's Exhibit No. 1496 (3A) (p. 12).

[305] Id., at 14659 and Commission's Exhibit No. 1502.

[306] Id., at 14691 and Commission's Exhibit No. 1502.

[307] Id., at 14691.

[308] Id., Commission's Exhibit No. C1514.

[309] Ibid.

[310] The Class B stock issued at 50 cents per share had an asset value of $2.31 per share on December 31, 1928 (ibid.).

[311] Public Examination, Sterling Securities Corporation, Commission's Exhibit No. C1514. At the close of 1928 only 263,797 Class B shares were outstanding. Part of the 48,298 shares referred to above as being distributed among officers and directors in 1928 and 1929 were not yet distributed (ibid.).

first convertible preferred stock.[312] The first preferred stock was offered to the public by Hayden, Stone & Company, a New York investment banking firm, and Insuranshares Corporation.[313] Hayden, Stone & Company received a gross selling commission of $4 per share, or $1,200,000, for the sale of the entire issue.[314] As a preliminary to the sale of this stock the corporation's directors wished to have the corporation's securities, with the exception of the Class B common stock, listed on the New York Stock Exchange.[315] The investment banking firm of Hayden, Stone & Company had been retained for the twofold purpose of aiding the company in its effort to secure a stock exchange listing and in marketing the issue of first convertible preferred stock.[316] In consideration of the prospective services on the part of Hayden, Stone & Company, Sterling Securities Corporation sold to Hayden, Stone & Company 100,000 shares of authorized but unissued Class A common stock at $12 per share and 25,000 shares of its authorized but unissued Class B common stock at the price of 50 cents per share.[317] At that time the Class A common stock possessed an asset value of $15 per share and had sold during the month of June 1929, at from $25⅜ to $28⅜ per share.[318] The elimination in the corporation charter of the common-law preemptive right of the Class A stockholders dispensed with the necessity of first offering to existing Class A stockholders the stock which was sold to Hayden, Stone & Company.[319]

Hayden, Stone & Company proceeded promptly to dispose of the 100,000 shares of Class A stock at a profit totaling $470,000.[320]

In July 1929 the New York Stock Exchange admitted to trading the preference stock and Class A common stock of Sterling Securities Corporation. As a condition of listing these securities the New York Stock Exchange demanded and obtained the elimination of the cumulative voting privileges of the Class B common stock of the corporation.[321]

The additional financing had the effect of almost doubling the amount of the fund over which the Class B stock exercised control and from the use of which the holders of the Class B stock could expect to earn large profits. The capital contributed by the outstanding 298,297 shares of the Class B stock totaled $149,148.50.[322] With the 25,000 shares of Class B stock sold to the new sponsor, Hayden, Stone & Company,[323] the management interests held approximately 248,297 shares of the Class B stock at a contribution of $124,148.50. Thus an investment of $124,148.50 afforded control over a total contributed capital of $32,475,898.50,[324] and was entitled to a very substantial part of the surplus profits earned by the company.

[312] Public Examination, Sterling Securities Corporation, at 14661.
[313] Id., at 14669 and Commission's Exhibit No. 1498.
[314] Id., at 14662.
[315] Id., at 14668.
[316] Ibid.
[317] Id., at 14661 and 14671.
[318] Id., at 14673.
[319] Ibid.
[320] Id., at 14677.
[321] Id., at 14659.
[322] Id., at 14666 and Commission's Exhibit No. 2001 (p. 260).
[323] Id., Commission's Exhibit No. 1498.
[324] Id., at 14662.

At June 30, 1931 the financial condition of Sterling Securities Corporation no longer presented the picture of December 1928.[325] The preference stock was under water to the extent of $8 per share; and the Class A stock had no asset value whatsoever; the Class B common stock had no asset value and no quoted market value.[326] Nevertheless, the sponsors of the company who still held the Class B stock were able to secure for their blocks of stock large sums of money in excess of the original cost. Atlas Corporation, which was seeking to obtain control of the corporation, paid large premiums to the sponsors who held the Class B stock [327] which, as has been noted, had no asset value and no quoted market value.[328] Thus, Atlas Corporation paid Walter R. Wolf $5 per share for 9,458 shares; [329] Scudder, Stevens & Clark $3 per share for 10,000 shares; [330] Daniel Pierce, a director of Sterling Securities Corporation, $3 and $5 per share for 4,000 shares; [331] Robert Pomeroy, another director of Sterling Securities Corporation, $4 per share for 3,000 shares.[332] On June 30, 1931, Atlas Corporation purchased 3,000 shares of Class B stock from Hayden, Stone & Company at a price of $3 per share [333] and 17,300 shares of this same stock from The Adams Express Company,[334] an investment company managed by Hayden, Stone & Company,[335] at a price of $4 per share. On July 22, 1931, Atlas Corporation entered into an agreement with the main sponsors of Sterling Securities Corporation, who still held the major blocks of the Class B stock, to purchase the Class B stock from them at $4 per share.[336] Pursuant to this agreement Atlas Corporation purchased 125,000 shares of Class B stock from these sponsors, including 24,700 shares from American Founders Corporation, 11,325 shares from Sterling Pile; 27,300 shares from Allied General Corporation; 6,200 shares from Insuranshares & General Management Company, with which Sterling Pile was affiliated; 6,600 shares from Edward S. Goodwin, a director of Sterling Securities Corporation; [337] and 17,075 shares from Edward B. Twombly and his associates.[338]

As these shares had been acquired at 50 cents a share, the sponsors, managers, and directors were able, at an extremely unfavorable period of the company's history, to retire from the company with large profits. The sale of 125,000 shares alone, recited above, netted the vendors a profit of $437,500.

In addition to these sales, some of the directors and sponsors had disposed of part of their holdings of Class B stock as early as 1928 and 1929, prior to the stock market decline, and had received even higher prices for their Class B common stock than those received from Atlas Corporation in 1931. Hayden, Stone & Company had sold 4,700

[325] Id., at 14731 and Commission's Exhibit No. 1505.
[326] Id., Commission's Exhibit No. 2043 and Commission's Exhibit No. 2001 (pp. 261–5).
[327] Id., Commission's Exhibit No. 1507.
[328] Id., Commission's Exhibit No. 2001 (p. 261).
[329] Ibid.
[330] Id., at 14763.
[331] Id., Commission's Exhibit No. 2001 (p. 261).
[332] Ibid.
[333] Id., at 14678.
[334] Ibid.
[335] Id., at 14674.
[336] Id., Commission's Exhibit No. 1507.
[337] Ibid.
[338] Id., Commission's Exhibit No. 1506.

shares for a profit of $101,050, and Walter R. Wolf had sold 18,875 shares for a profit of $223,181.18.[339]

Walter R. Wolf, one of the organizers of Sterling Securities Corporation, when examined on the consequences of the issuance of the Class B common stock, testified:[340]

Q. In any event, if we can analogize, it was as if the insiders, the people who had the management stock, had an interest in a margin account with a brokerage firm of $32,000,000 when their contribution was $174,000, and they got a cut of 25% of the profits after allowing the people who put in the $32,500,000 six percent; isn't that so?

A. Yes; I think substantially so.

* * * * * * *

Q. The point I was trying to bring out is, don't you think there ought to be some limitation on the relationship of the senior money and junior money? Otherwise you will get a situation when a person pays 50 cents a share for stock and he is gambling with the public's thirty-two and a half million dollars of money. What has he got to lose? If the stock goes sour he is out 50 cents, but if he makes a killing, his stock goes right through the ceiling.

A. That is correct.

Q. So the only thing he had to lose is his 50 cents stock, and he has the privilege of speculating or gambling or trading his fool head off if he wants to take that chance?

A. Yes.

The inequity in such disfranchisement of the holders of the senior securities of complex-structure investment companies, who frequently contribute the major investment in the company, is illustrated by this company. The preferred stockholders of Sterling Securities Corporation, who were the "owners" of the assets of the corporation, were not consulted on the matter of the transfer of control of the company to Atlas Corporation.[341]

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[339] Id., at 14678, 14695–6.

[340] Id., at 14710–14.

[341] Mr. Twombly, a member of the management of Sterling Securities Corporation, testified (id., at 14729–37):

Q. They owned the senior securities, and it was their money?

A. They had nothing to say about the change in management, and they were not notified of the change in management prior to its taking place.

Q. But there was nobody there at the time control was turned over to say, "I won't let this thing go through unless I was sure that the people who put in the $32,500,000 get a good deal on their stock," was there?

A. No.

* * * * * * *

Q. This is an illustration of the lightning speed at which a transfer of other people's money in the investment trust field——

A. You mean control of it?

Q. Yes.

A. Yes.

Q. Do you think that is a healthy situation?

A. I didn't.

Q. You probably felt some sense of obligation to these people (the holders of senior securities)?

A. I probably did.

Q. And you probably had a feeling that these people had invested this money and turned over the management of the fund to you?

A. This is why I stayed on the board of directors.

Q. You can visualize the situation back in '31 when there were some people who hadn't even heard of Atlas until this time.

A. That is right.

Q. And they wake up one morning and find themselves with their funds being administered by the Atlas * * * Company?

A. That is so.

Q. Without their expressed consent, anyway?

(3) UNITED FOUNDERS CORPORATION

A number of illustrations have been cited of the fairly common practice of sponsors of obtaining the major or substantial part of the class of security which secures them a voting power and an interest in the surplus profits much greater in proportion than their contribution to the capital of the company. The element of control is sometimes regarded as so significant that a diversity of securities is introduced in the capital structure merely to attain that end alone, without seeking to allot to the class of stock disproportionately weighted with the voting power a share in surplus profits disproportionate to the amount contributed. United Founders Corporation is an illustration of a company issuing two classes of common stock with a control objective alone.

Upon organization, United Founders Corporation issued two classes of securities, one being designated as Class A common stock, the other simply as "Common Stock." [342]

The certificate of incorporation granted the Class A stock, as a class, a vote equal to one-half the voting power of the total outstanding common stock, irrespective of the amount of common stock which might be issued and irrespective of the amount contributed by the Class A stock and common stock to the capital of the company.[343] Hence the Class A stock, as a class, carried, at all times, 33⅓% of the company's total voting power.

In respect to earnings and distribution of assets upon dissolution or liquidation, however, the certificate of incorporation prescribed that the Class A stock should share in the proportion that its contribution to the capital bore to the total capital contributed by both classes of stock.[344]

In February 1929 the promoters, Louis H. Seagrave, Christopher F. Coombs, and Frank B. Erwin, had received an aggregate of 1,000,000 shares—the total authorized amount—of Class A stock, divided equally among them. They had paid for this block of stock by transferring to United Founders Corporation 12,500 shares of American Founders Corporation common stock having a market value at the time of approximately $1,000,000.[345] By June 1933 approximately 9,000,000

A. That is right.

Q. You had no disclosure as to what their future policy was going to be?

A. That is right.

Q. What disposition was going to be made of their money, how it was going to be invested?

A. That is right.

Q. That is a little more than not even being a healthy condition. I frankly would like to get your views on this problem of transfer of control of investment trusts.

A. I am a great believer in stockholders' control of management, if that is what you want.

[342] Public Examination, American General Corporation et al., Commission's Exhibit No. X3421 (pp. 39 and 41).

[343] Id., Commission's Exhibit No. X3420–B.

[344] The share of the Class A stock in earnings and the distribution of assets is described as follows: "* * * the proportion that the amount theretofore contributed to the capital and/or paid-in surplus of the Corporation by the holders of the Class A stock bears to the total amount theretofore contributed to the capital and/or paid-in surplus of the Corporation by the holders of both Class A or Common Stock * * *" (Public Examination, The Equity Corporation, Exhibit 745 [p. 6]).

[345] Public Examination, American General Corporation et al., Commission's Exhibit No. X3420 (Ex. D–1); Public Examination, The Equity Corporation, Commission's Exhibits Nos. 751–752.

shares of United Founders Corporation "Common Stock" had been distributed, principally to the public and at varying prices, for a net contribution to the company's capital of approximately $297,000,000.[346] Although sponsors' contribution for the Class A stock amounted to only 1/298 of the total investment in the company, they still held one-third the total voting power by virtue of their ownership of the Class A stock and wielded working control of the company. Moreover, United Founders Corporation held 78.7% of the voting stock of American Founders Corporation, which, in turn, controlled five other large investment trusts, the total consolidated assets of these companies amounting in June 1933 to approximately $50,000,000.[347]

However, by June 1933 United Founders Corporation itself had suffered tremendous losses. The contrast at this time between the asset value of the Class A stock and the voting power represented by it is particularly striking. The net assets of the company had shrunk in value to approximately $14,300,000.[348] The asset value of the entire Class A stock, determined by the proportion of the contribution of the respective classes of stock to the capital of the company, was 1/298 of $14,300,000, or approximately $48,000.[349] The voting power of this Class A stock, however, remained unchanged—33⅓% of the total voting power of all outstanding securities. It should be noted that voting control of United Founders Corporation carried with it control over the combined resources of the affiliated and subsidiary investment companies.

The significance to promoters of the ability to diversify the rights represented by different classes of securities is evidenced in the following testimony of David M. Milton, president of The Equity Corporation, which paid a large premium to Messrs, Seagrave, Coombs, and Erwin for the privilege of succeeding the latter in the control of United Founders Corporation: [350]

Q. But there was very little value in the Class A stock, as I understand your testimony?

A. You are talking about underlying value, asset value.

Q. I understand you to say about the only value it had was in the form of control.

A. But that is a very definite value. In other words, as the financial community looked at those stocks in those days, I don't think there is any question about it; that it had a very definite value. I mean there were a large number of stocks which had no asset value, which were selling at definite values, and this type of control stock had a very definite market value, if you want to call it that, because it carried that voting power.

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[346] Public Examination, The Equity Corporation, Commission's Exhibit No. 764.

[347] Id., at 8276 and Commission's Exhibit No. 843; Public Examination, American General Corporation et al., Exhibit No. X3420 (Ex. E–8).

[348] Op. cit. supra, note 346, at 8556 and Commission's Exhibit No. 797.

[349] Id., Commission's Exhibit No. 797.

[350] Id., at 8693. For details of the transfer of control to The Equity Corporation by the latter's purchase of 666,666⅔ shares of Class A and 635,000 shares of common stock of United Founders Corporation from Mr. Coombs and Mr. Erwin, see Ch. IV of this part of the report.

(4) INSURANSHARES CORPORATION OF DELAWARE

Under the original capitalization of Insuranshares Corporation of Delaware, the Class A common stock sold to the public brought $15,000,000 to the company, while the Class B common stock sold to the promoters brought only $50,000. Yet the Class B common stock, contributing $\frac{1}{300}$ of the capital, controlled the company and was entitled to 15% of the surplus profits of the company. Moreover, the significance of the Class B stock was so great that on three successive occasions the group that currently held that stock was able to transfer control of the company at premiums over the asset value and market value of these shares.

The corporation was organized in Delaware, July 31, 1928,[351] at the instance of Insuranshares Corporation of New York, a corporation engaged in the public distribution of securities,[352] and Insuranshares Management Company.[353] Both of these corporations were then controlled by Sterling Pile; Edward B. Twombly, an attorney,[354] Schoellkopf, Hutton & Pomeroy, Inc., investment brokers,[355] and Goodwin Beach & Company, a firm specializing in insurance securities,[356] headed by Edward S. Goodwin.[357] Within a few months after the formation of the company, The Goldman Sachs Trading Corporation, another investment company, became an additional sponsor of the company.[358]

The authorized capital of the corporation consisted of Class A common stock and Class B common stock, both of which were without par value.[359] The Class A common stock was distributed at $20 per share net to the corporation,[360] while the Class B common stock was sold at 10 cents per share.[361] The Class A common stock partook of the nature of a senior security, as it was entitled to a noncumulative dividend, after 1929, at the annual rate of 60 cents per share and upon liquidation to a preference in assets to the extent of $20 a share. The surplus earnings and assets were divisible in the following proportions: 85% to the Class A common stock and 15% to the Class B common stock.[362]

A significant distinction was made with respect to the right of the two classes of stock in the election of directors—each 10-cent share of Class B common stock was granted three times the voting power of each $20 share of Class A stock. The Class A stock had one vote per share multiplied by the number of directors to be elected, whereas the Class B stock had three votes per share multiplied by the number of directors to be elected.[363]

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[351] *Moody's Manual of Investments, Banks, etc.*, 1931, at 2713.

[352] Public Examination, Allied General Corporation, at 5042.

[353] Id., at 4950.

[354] Id.. at 4947.

[355] Id., at 4948.

[356] Id., at 4948 and 4996.

[357] Id., at 4948.

[358] Id., at 5046 and 5048; Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1908; and Public Examination, First Income Trading Corporation et al., at 1054.

[359] Op. cit. supra, note 352, at 5047.

[360] Id., at 5054.

[361] Id., at 5047.

[362] *Moody's Manual of Investments, Banks, etc.*, 1931, at 2714; Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1908.

[363] Ibid.

By the close of March 1929 Insuranshares Corporation of Delaware had raised a total of $15,050,000, of which $15,000,000 represented the consideration for the issuance of 750,000 shares, of its Class A stock and $50,000 represented the net amount received by the corporation for the sale of 500,000 shares of its Class B common stock.[364] On March 1, 1929, Insuranshares Corporation of New York had purchased 50,000 shares of the Class B stock and Insuranshares Management Company the remaining 450,000 shares of Class B stock at a price of 10 cents a share.[365] In March 1929, also, The Goldman Sachs Trading Corporation had purchased 250,000 shares of the Class A stock for $5,000,000. On March 14, 1929, Insuranshares Corporation of New York publicly distributed 500,000 shares of the Class A stock for net proceeds to the corporation of $10,000,000.[366] On March 5, 1929, The Goldman Sachs Trading Corporation had purchased from Insuranshares Corporation of New York 25,000 of the 50,000 shares of Class B stock which the latter had acquired several days earlier.[367] Thus, by the latter part of 1929, Insuranshares Corporation of Delaware had issued 500,000 shares of Class B stock for $50,000, 450,000 shares of which were in the hands of Insuranshares Management Company, 25,000 shares held by Insuranshares Corporation of New York, and 25,000 shares by The Goldman Sachs Trading Corporation. It had issued 750,000 shares of Class A common stock for net receipts of $15,000,000.

As the Class B stock had been granted threefold voting power in respect to the election of directors, the aggregate voting power of Class B stock was twice as much as the aggregate voting power of Class A stock. The holding by Insuranshares Management Company of Class B stock of Insuranshares Corporation of Delaware insured to it effective control of Insuranshares Corporation of Delaware, as well as a very substantial part of the surplus earnings of the company.[368] The New York Curb Exchange, in May 1929, objected to the listing of the Class A stock on the ground of the inequity of the multiple voting power of the Class B stock when compared with the relative capital contributions of the two classes of stock. Insuranshares Management Company, Insuranshares Corporation of New York, and The Goldman Sachs Trading Corporation, the owners of the entire 500,000 authorized shares of the Class B stock, thereupon agreed that they would not vote more than one-third of the number of shares of Class B stock owned by them in the election of directors while the Class A stock remained listed on the New York Curb Exchange until such time as the company should have issued a total of 1,500,000 of Class A shares which would bring the measure of voting power of the entire Class A stock up to that of the Class B stock.[369]

On May 14, 1931, Insuranshares Corporation of Delaware was recapitalized under a plan whereby the outstanding 750,000 shares of

[364] Op. cit. supra, note 358.

[365] Op. cit. supra, note 352, at 5048, and Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1908.

[366] Op. cit. supra, note 358.

[367] Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1908.

[368] Ibid.

[369] Ibid.

Class A stock were exchanged for 375,000 shares of new "common stock" and the outstanding Class B shares were exchanged for an issue of half the number of Class B shares—to wit, 250,000 shares.[370] The new common shares were entitled to noncumulative dividends at the annual rate of 3%. The fixed preference of $20 per share in liquidation possessed by the former Class A stock was eliminated, the new "common stock" receiving only the right to 85% of the corporate assets on any liquidation of the company, and the new Class B stock receiving the right to the residue of the corporate assets. The voting rights of the two classes of stock remained unchanged.[371]

As part of the recapitalization plan, the common stockholders were offered, in July 1931, the right to subscribe to 93,750 shares at $9 per share. The new offering resulted in an additional $843,750 of capital.[372]

The first change in control of Insuranshares Corporation of Delaware was consummated toward the end of 1931. From March 1930 to September 1931 United Founders Corporation, an investment company which had been formed in 1929, and its subsidiaries, including American Founders Corporation, had been engaged in a policy of accumulating "common" stock of Insuranshares Corporation of Delaware and particularly stock of Insuranshares Management Company, which held the Class B stock of Insuranshares Corporation of Delaware. By April 21, 1932 United Founders Corporation and its subsidiaries had acquired a total of 161.605 shares of the common stock of Insuranshares Corporation of Delaware, or 34% of the 468,750 shares of such stock then outstanding, and 153,000 shares, or 51% of the 297,509 shares of the capital stock of Insuranshares & General Management Company (the new name adopted by Insuranshares Management Company in May 1930).[373] These holdings of "common stock" of Insuranshares Corporation of Delaware, and of the capital stock of Insuranshares & General Management Company, gave United Founders Corporation and its subsidiaries effective control of Insuranshares Corporation of Delaware.[374] By April 1932 United Founders Corporation and its subsidiaries had suffered severe unrealized losses on their holdings of the securities of Insuranshares Corporation of Delaware and of Insuranshares & General Management Company. The total cost of the securities to the United Founders Corporation group had been about $5,800.000, of which approximately $4.600,000 had been paid for the 161,605 shares of common stock of Insuranshares Corporation of Delaware, and approximately $1,200,000 had been paid for the 153,000 shares of stock of Insuranshares & General Management Company then held by the United Founders Corporation group.[375] The latter amount paid for

[370] *Moody's Manual of Investments, Banks, etc.*, 1932, p. 2179.

[371] Ibid.

[372] Ibid.

[373] *Poor's Banks, etc.*. 1932, p. 1581, and Public Examination, First Income Trading Corporation, et al., Commission's Exhibit No. 98.

[374] Insuranshares Management Company had acquired 450,000 Class B shares of Insuranshares Corporation of Delaware for $45,000 at the organization of the latter company. By the end of 1931 Insuranshares & General Management Company had acquired the remaining 50,000 shares of the Class B stock of Insuranshares Corporation of Delaware (op. cit. supra, note 367, Commission's Exhibit No. 1908; *Moody's Manual of Investments, Banks, etc.*, 1933, p. 2508).

[375] Derived from supplementary information supplied the Commission for United Founders Corporation; also op. cit. supra, note 373.

the stock of Insuranshares & General Management Company was in part a premium on behalf of Class B stock of Insuranshares Corporation of Delaware held by Insuranshares & General Management Company. By April 1932, these holdings, which had cost the United Founders Corporation group close to $6,000,000, had depreciated tremendously in both market and asset value.[376]

On April 21, 1932, United Founders Corporation and its subsidiaries entered into an agreement with Insurance Equities Corporation, recently formed by Frank Cohen,[377] who was in control of Lloyds Casualty Company of New York and Detroit Fidelity & Surety Company for the sale to Insurance Equities Corporation of the entire holdings of the United Founders Corporation group in the stocks of Insuranshares Corporation of Delaware and in Insuranshares & General Management Company. The price to be paid to the American Founders Corporation group of companies was approximately equal to the asset value of the securities and more than $600,000 in excess of the market value of the shares at that time.[378]

Insurance Equities Corporation, as well as its dominating influences, Frank Cohen and Julius H. Barnes, was without funds[379] to make to American Founders Corporation, the agent for the United Founders Corporation group, even the down payment of $450,000 which by contract was due on May 3, 1932.[380] American Founders Corporation permitted Mr. Cohen and Mr. Barnes to elect eight of the twelve directors of Insuranshares Corporation of Delaware, and thus take over control of that company on May 3, 1932, prior to receipt by American Founders Corporation of any portion of the purchase price.[381]

Mr. Cohen and Mr. Barnes engaged in a series of intricate intercorporate maneuvers in an effort to pay American Founders Corporation the agreed-upon sums.[382] In substance, the technique adopted by them was to liquidate the portfolio of Insuranshares Corporation of Delaware, siphon the proceeds into Insurance Equities Corporation through the sale by the latter to Insuranshares Corporation of Delaware of the securities of minor insurance companies, and to transfer the cash obtained by Insurance Equities Corporation to American Founders Corporation.[383] Thus, in effect, the United Founders Corporation group was being paid for its controlling interest in Insuranshares Corporation of Delaware by the liquidation of the assets of Insuranshares Corporation of Delaware.[384]

Although Mr. Cohen and Mr. Barnes continued the policy of raising cash to make payments to American Founders Corporation by

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[376] See Ch. IV of this part of the report, p. 1197.

[377] Public Examination, First Income Trading Corporation, et al., at 1057.

[378] Public Examination. First Income Trading Corporation, et al., Commission's Exhibit No. 98; and see Ch. IV of this part of the report, p. 1204.

[379] Public Examination, First Income Trading Corporation, et al., at 1057.

[380] Id., at 1057 and Commission's Exhibit No. 98.

[381] Stenographer's minutes, *Benedict* v. *Seagrave,* pp. 289, 336, 207–9, and 291–2.

[382] The details of these activities are given in Ch. IV of this part of the report, pp. 1017 et seq.

[383] Public Examination, First Income Trading Corporation, et al., at 1058–9.

[384] From the beginning of February 1932 to May 30, 1932, while the United Founders Corporation group was still managing the activities of Insuranshares Corporation of Delaware, it had caused Insuranshares Corporation of Delaware to liquidate portfolio securities costing approximately $1,770,000 for $360,833.42 (Public Examination, First Income Trading Corporation et al., Commission's Exhibit No. 99).

liquidating at apparently sacrifice prices the marketable securities of Insuranshares Corporation of Delaware, they were unable to make all the required payments even though a number of extensions of time were granted by American Founders Corporation. By the close of March 1933, Insurance Equities Corporation had succeeded in paying all but approximately $175,000 of the purchase price due American Founders Corporation on the contract for the transfer of control of Insuranshares Corporation of Delaware.[385] A note for $180,000 had been under default since November 1932. American Founders Corporation, however, still retained the 153,000 shares of stock of Insuranshares and General Management Company (which controlled all the Class B stock of Insuranshares Corporation of Delaware) as collateral for that obligation. Unable to obtain the balance due from Insurance Equities Corporation and Mr. Cohen and Mr. Barnes, American Founders Corporation sold the collateral to one John H. Orgill.[386] American Founders Corporation received $100,000 for this collateral, consisting of 153,000 shares of Insuranshares and General Management Company's stock which controlled the Class B stock of Insuranshares Corporation of Delaware.[387]

It is an interesting commentary upon the values imparted to the Class B common stock by the structural set-up that, despite the vicissitudes which Insuranshares Corporation of Delaware had experienced and the impoverishment which the company had undergone, the Class B shares of that investment company brought twice as much money at the end of 1933 as had originally been paid for the same by the sponsors in the beginning of 1929.

In December 1937, when the assets of Insuranshares Corporation of Delaware totaled $800,000 as compared to the approximately $15,000,000 invested in the company by its stockholders, the control of the company was again transferred to a new group, consisting of S. Leo Solomont, Ralph H. Robb and Thomas H. Morris, who also used the assets of Insuranshares Corporation of Delaware to pay for their control of the company. As a result of the activities of this group, $500,000 of diversified marketable securities of Insuranshares Corporation of Delaware were replaced by securities having little or no value.[388]

(5) UNION INVESTORS, INC.

On June 23, 1928, one R. B. Parrott who had been president of an Iowa farm-mortgage company [389] and was apparently without experience in the operation of an investment company, caused the incorporation, under the laws of Delaware, of Union Investors, Inc.[390] The corporation did not commence active business until November 1928.[391] By that time Mr. Parrott had succeeded in securing Ray Vance, an

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[385] Id., at 1060.

[386] Stenographer's minutes. *Benedict* v. *Seagrave*, Supreme Court of the State of New York, Special Term, Pt. IV, Index No. 45607 (1933, pp. 1563–4).

[387] Ibid.

[388] For a detailed discussion of this last transfer of control of Insuranshares Corporation of Delaware, see Ch. II of this part of the report, pp. 438–48 and pp. 475 et seq.

[389] Public Examination, The Equity Corporation, at 1647.

[390] Id., at 1374–5 and 1648.

[391] Derived from supplementary information supplied the Commission for Union Investors, Inc.

investment counselor,[392] George E. Dyke, an associate of the New York brokerage firm of Lindley & Company,[393] F. W. ter Meullen, the American representative of various Dutch financial institutions,[394] and Robert Gair, Jr., as fellow directors.[395] The business contacts of these directors were apparently of some aid to Mr. Parrott in his distribution of the securities of Union Investors, Inc.[396] Each of the directors was given an option by Mr. Parrott to purchase from him a block of the Class B stock of the corporation at 50 cents a share.[397] Mr. Parrott had acquired the exclusive right to purchase from the corporation, at 50 cents a share, all of its authorized Class B stock which had been awarded by the Articles of Incorporation a right to a disproportionate share of assets on dissolution.

The authorized securities of Union Investors, Inc. consisted of a preferred stock having a par value of $20 a share and entitled, upon any dissolution of the corporation, to a first claim against the corporate assets to the extent of $20 per share, a Class A common stock, and a Class B common stock. The Class A common stock and Class B common stock each had one vote per share; the preferred stock had no voting power. On any dissolution of the corporation, the Class A stock was entitled to two-thirds and the Class B to one-third of all the corporate assets remaining after satisfaction of the prior claims of the preferred stock.[398]

The Class B stock was placed in a voting trust of which Mr. Parrott and two of his nominees, Mr. Kelly and Mr. Zizinia, were the trustees.[399]

On November 13, 1928, Mr. Parrott, the dominating influence in Union Investors, Inc., awarded to himself the exclusive right for a period of two and one-half years (expiring on May 13, 1931) to purchase and distribute the corporation's securities. The contract permitted Mr. Parrott to purchase the preferred stock at $20 a share, the Class A stock at $9.40 a share, and the Class B stock at 50 cents a share.[400]

The pecuniary advantage to Mr. Parrott of his privilege to purchase Class B shares at 50 cents each is obvious in view of the fact that on liquidation of the corporation it had a right as a class to receive one-third of the corporate assets remaining after satisfaction of the preferred stock claim against the assets. Class A stockholders, who contributed to the corporation $9.40 for each of their shares, suffered an immediate dilution in favor of the Class B stock of approximately 30% of their contribution to the corporation. In other words, on receipt by the corporation of $9.90 for one share of its Class A stock at $9.40 and one share of Class B stock at 50 cents, the Class B stock, by virtue of the corporation's charter, acquired an immediate liquidating value of $3.30, whereas the Class A stock retained a liquidating

392 Public Examination, The Equity Corporation, at 1644.

393 Id., at 1706.

394 Id., at 1670 and Commission's Exhibit No. 198.

395 Id., at 1670.

396 Id., at 1672.

397 Id., at 1665 and 1672.

398 Id., at 1648–50.

399 Derived from supplementary information supplied the Commission for Union Investors, Inc.

400 Public Examination, The Equity Corporation, Commission's Exhibit No. 187.

value of only $6.60. Ray Vance, the president of Union Investors, Inc., characterized the Class B stock as "one of those management stocks which went in so many trusts and they all got that same kind of an advantage.[401]

By December 31, 1929, Union Investors, Inc. had raised a total of approximately $952,860 through the sale of 870 shares of its preferred stock, 96,000 shares of Class A stock, and 69,600 shares of Class B stock.[402] It is doubtful that many of the Class B shares were sold to the public. The bulk of the outstanding Class B shares seem to have been held by Mr. Parrott and the directors of Union Investors, Inc. In fact, 27,600 of the Class B shares were purchased by the directors in November and December of 1929 with knowledge of the prospective exchange offer for the securities of Union Investors, Inc. to be made by Yosemite Holding Corporation.[403] The profit to these directors on these purchases of Class B shares will be indicated hereinafter.

The total fund of $952,860 raised by the sale of the corporation's securities had been invested in a diversified portfolio of securities.[404] As at December 31, 1929, however, after the market crash, the assets of the corporation had a value of approximately $680,000.[405] In other words, as a result of the October 1929 crash in security values, the corporation's capital had depreciated approximately 29%.

By the summer of 1929, Mr. Vance and his co-directors had become dissatisfied with the unsuccessful efforts of Mr. Parrott to distribute further substantial blocks of the securities of Union Investors, Inc.[406] The directors themselves had purchased by December 31, 1929, approximately 65% of the Class A stock which had been sold by Mr. Parrott. Further, Mr. Vance and his co-directors felt that they had been "trapped"[407] by Mr. Parrott into an inequitable capital structure. Their own purchases of Class A stock had constituted approximately 65% of the corporation's capital, but Mr. Parrott's holdings of the Class B stock which he had purchased at a price of 50 cents a share, entitled him as a holder of the Class B shares to a pro rata share of approximately one-third of the corporate assets. Because of the "bad capitalization" and of the alleged inefficiency of Mr. Parrott's distribution of Union Investors, Inc. securities, Mr. Vance and his associates were anxious to bring to an end Mr. Parrott's association with the corporation. Mr. Vance testified:[408]

A. * * * In the first place we felt we were more or less trapped into a bad capitalization * * * in the second place we felt that the distributing power of Parrott & Company was wholly inadequate to ever make the trust of any particular size. Then they wanted to get rid of the man that created that kind of capitalization.

Q. Who was he?

A. Mr. Parrott.

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[401] Id., at 1664.

[402] Id., at 1652. Substantially all of this capital was raised through the sale of the Class A stock (ibid.).

[403] Id., at 1668.

[404] Id., at 1385.

[405] Id., at 1412.

[406] Id., at 1653-4.

[407] Id., at 1659.

[408] Ibid.

In November 1929, Mr. Vance and the other directors secured Mr. Parrott's cooperation in an exchange of the Class A and Class B stock of Union Investors, Inc. for the stock of Yosemite Holding Corporation, a newly formed investment company. The exchanges resulted in the receipt by the holders of Class B stock of stock of the new company having a market value of $4.20 and an asset value of $1.27 for each share of the Class B stock for which the latter had originally been paid 50 cents per share. The terms and conditions under which the transfer of control of Union Investors, Inc. was effected and the profit to Mr. Parrott and the other directors on their Class B stock has been described in another chapter of this report.[409]

c. Comparison of Contribution by Senior and Junior Capital and the Rights Obtained by Sponsors and Public for their Respective Contributions

The acquisition by sponsors, for a minor investment, of "control" generally accompanied by the right to a disproportionately large share of the profits and affording the opportunity of disposing of the control at a premium has been a constant and regular feature of the complex capital set-up. Appendix I (pp. 1937 et seq.) discloses, in mathematical ratio, additional instances of the disparity between contribution by sponsors and rights obtained by them. The appendix also shows the initial structural leverage of these companies, i. e., the comparative contribution to the capital for the senior and equity securities, respectively.

2. FACILITY OF TRANSFER OF "CONTROL" OF INVESTMENT COMPANIES TO THE ADVANTAGE OF RETIRING SPONSORS AND TO THE DETRIMENT OF THE REMAINING SECURITY HOLDERS[410]

It has been indicated that the complex capital structure enables the sponsor to secure control of the company with a relatively small investment. While the sponsor retains his control holdings, he is the arbiter of the affairs of the company, which power he may exercise to his personal advantage. The value of the "control stock" to a sponsor is not limited to the period when he is exercising his influence over the affairs of the company. He is in a position to transfer the control of the investment company to anyone who is willing to pay the price. Thus, the management of the company may be passed on without the consent of the investors who have contributed the bulk of the funds. The Study has demonstrated that comparatively rarely does the purchaser of control from a previous sponsor seek control for the purpose of strengthening the position of the investor in the company. The motive, or at least the result, has generally been the utilization of the investment company for the special designs of the purchaser of control, often in disregard of the interests of the investor.

The practice of sponsors of delivering the control of investment companies into new hands without prior notice to, or the consent of.

[409] See Ch. IV of this part of the report, pp. 1296–1301.

[410] For detailed discussion of shifts in control of investment companies see Ch. IV of this part of the report, pp. 1017 et seq.

the public security holders, has been characterized by some representatives of the industry as "trafficking in investment companies," and "selling the security holders down the river." Such transfers of management involve an element of breach of faith on the part of the original sponsor toward the body of security holders of the investment company. The sponsors of investment companies, in inviting the investor to entrust his funds to their management, emphasize the integrity, responsibility, dependability, and competency of the particular management of the company. Manifestly, a great percentage of the investment in a particular company is induced by reliance of the investor upon the individual sponsor and in his ability to operate the company expertly and conscientiously. Consequently, some element of abuse of confidence is involved when the sponsor abdicates and subjects the company to a new control and management, of which the investor has not been apprised or to which he has not consented.[411]

Carroll E. Gray, Jr., who in June 1932 bought, and in March 1938 sold, control of Burco, Inc., an investment company, after stating that no announcement, public or private, was given to stockholders of the transfer of control, testified that such notice had not, to his knowledge, ever been vouchsafed before:[412]

Q. Yet you felt you owe no duty or that it would have been, shall I say, well—the new thing to do to say, "Mr. Preferred Stockholders, I manage your money. I hold the common stock. I have been trading in securities on your money. For reasons best known to myself, I would like to turn over the management of your money to somebody else." What do you think about it?

A. I think it is utopian.

Q. You think it is utopian? And why, because it is decent.

A. Can you cite a case, a similar case, in corporate history?

Q. Well, by utopian you mean it was not an impossibility? You mean it had never been done before to your knowledge?

A. Correct.

Q. * * * It was not physically impossible for you to do it?

A. Not physically impossible.

Q. You mean that your concept of the mores and ethics of corporate and investment trust finance is such that it is utopian to tell the people whose money you are controlling that you contemplate turning over the control of their money to somebody else?

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[411] Earl Bailie, chairman of the board of directors of Tri-Continental Corporation, testified (Public Examination, Tri-Continental Corporation, at 18874–5):

Q. You say "how will they justify to the stockholders of these companies this 'selling down the river' by a governmental body which does not consult their wishes and does not guarantee the success of the management which must replace the present officers and directors?" I am interested in this "selling down the river." We have a different phrase for an analogous situation, and that is the business of "trafficking in investment trusts."

A. Yes; and I have tried to cover that by saying I did not think management should be able to be transferred.

Q. There is no reference here [Mr. Bailie's recommendation with reference to regulation of investment companies], is there?

A. Then limit it at this point. I puzzled a great deal over the practical method of working out what I am going to say. But, I think before a group of stockholders have a wholesale shift in the directors or management that they should be consulted in a meeting and should know who their new managers are. You will realize that comes under one of my suggestions that the new directors and their affiliations and past connections have to be outlined and sent out.

[412] Public Examination, First Income Trading Corporation et al., at 876 and 881–5.

A. No; I did not say that. I said that when you purchase an interest in a company with cash administered to the best of your ability, it is perfectly proper that you should sell it.

* * * * * * *

Q. You could change the fundamental nature of that business overnight by changing from a trading corporation to a diversified long-pull investment company?

A. That is correct.

* * * * * * *

Q. And people may have retained their stock in reliance of the fact that they were still going to be in the trading corporation; is not that so?

A. That is right.

Q. You would not say, Mr. Gray, that if you were going to change the fundamental nature of the investment trust that the stockholders should not be considered on that question?

A. They should be.

Q. However, when it came to questions of transferring the power to change the fundamental nature then you say that is utopian; is that right?

A. Correct.

Q. Now, did you get any written provision in the agreement to the effect they would maintain the same policy, Mr. Gray?

A. No.

The substantial change in the situation of the investor who, without prior warning, finds his company administered by new forces in whom he may have no confidence, is implicit in every case of transfer of control, even in those instances in which the new management is qualified and well-intentioned. More serious, however, are the illustrations of sponsors exhibiting few scruples as to the identity, qualifications, or motives of the new management which they were imposing upon the company, or the surrender of control of the company to individuals or groups whose objectives they knew or should have known were other than the welfare of the company or the general body of investors in that company. In some instances the retiring sponsors at least passively acquiesced to the acts of the incoming management in the furtherance of designs inimical to the welfare of the companies or its investors.

a. Insuranshares Corporation of Delaware and United Founders Corporation

In the case of the transfer of the control block of stock of Insuranshares Corporation of Delaware by United Founders Corporation to Insurance Equities Corporation, described above, United Founders Corporation, the retiring sponsor, permitted Insurance Equities Corporation (the specially created instrumentality of Mr. Cohen and Mr. Barnes, the incoming sponsors) to liquidate the portfolio of Insuranshares Corporation of Delaware, consisting of dividend-paying insurance company and bank stocks, and to take the cash proceeds of such liquidation in exchange for obscure insurance companies' securities.[413] The cash siphoned out of Insuranshares Corporation of

[413] See supra, pp. 1634–7. United Founders Corporation (and its subsidiaries) had effective control of Insuranshares Corporation of Delaware by virtue of its holding of 51% of the capital stock of Insuranshares & General Manegement Company, which held the Class B stock of Insuranshares Corporation of Delaware (ibid.).

Delaware in this manner was then paid over by Insurance Equities Corporation to American Founders Corporation, the agent for United Founders Corporation. During the period of the control by Insurance Equities Corporation, Insuranshares Corporation of Delaware was caused to liquidate virtually its entire portfolio, which had been acquired at a cost of approximately $15,000,000, for approximately $4,500,000 cash. The draining out of the cash proceeds of this liquidation and the substitution therefor of obscure securities furnished by the new sponsors, on which the company suffered an additional loss, was a further sacrifice of the interest of the general security holders of Insuranshares Corporation of Delaware stemming from the transfer of control.

The "trafficking in control" facilitated by the existence of a "control" class of security is illustrated by several such episodes in the history of Insuranshares Corporation of Delaware. The primary original sponsor was Insuranshares Management Company. By August 1933, control had been shifted to the United Founders Corporation group of investment companies. In April 1932 the United Founders Corporation group sold its controlling interest to Insuranshares Equities Corporation. In December 1933 the stock representing the control of Insuranshares Corporation of Delaware, at that time practically drained of all assets, was turned over to John H. Orgill; and in 1937 it was transferred to Messrs. Robb, Solomont, and Morris, and the Northern Fiscal group of investment companies, with whom they were associated.[414]

b. Accumulation of Investment Companies by Wallace Groves Through Purchase of "Control" Stocks

Another example of the unrestricted trafficking in investment companies is to be found in the activities, in 1931 and 1932, of Wallace Groves, who prior to that time had not been affiliated with any major investment banking, commercial banking, or brokerage operations.[415]

Wallace Groves started his career as investment company sponsor by buying control, at about the same time, of three closed-end management investment companies, to wit: Interstate Equities Corporation, Chain & General Equities, Inc., and Yosemite Holding Corporation. The three companies had aggregate net assets of approximately $11,000,000.[416]

All three companies had capital structures consisting of preferred and common stocks. In each case, the company was subject to the control of the equity stock which had an insubstantial market value and a very slight or no asset value. In each instance the current sponsor of the company transferred control to Mr. Groves either by selling him its own "control" stock or causing the company to sell Mr. Groves

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[414] See Ch. II of this part of the report, pp. 350–496.

[415] A detailed history of Wallace Groves in the investment company field will be found in Ch. II of this part of the report, pp. 181–226.

[416] In October 1931 Interstate Equities Corporation had net assets of $8,636,431 (Public Examination, The Equity Corporation, Commission's Exhibit No. 18). As of September 30, 1931, Chain & General Equities, Inc., had net assets of $1,978,077 (id., Commission's Exhibit No. 9). Yosemite Holding Corporation had net assets as of September 30, 1931, of $313,960 (id., at 1367 and Commission's Exhibits Nos. 28 and 31, and derived from supplementary information supplied the Commission for The Equity Corporation).

common stock. In each case Mr. Groves contracted to pay a substantial premium above the asset value of the equity stock. At the time of the making of the contracts he did not personally possess the financial resources to pay the contract price of the equity stocks amounting to almost $2,250,000.[417]

Bancamerica-Blair Corporation and Hunter Marston, a director of both Bancamerica-Blair Corporation and Interstate Equities Corporation, contracted to sell Mr. Groves 642,517 shares of common stock of Interstate Equities Corporation, constituting 46% of the voting power, for $963,755.50,[418] at a premium of $687,493.19 above the asset value of the shares.[419] Chain & General Equities, Inc. undertook to issue to Mr. Groves 467,938 shares of common stock, constituting 72% of the total outstanding voting stock, for $935,876,[420] at a premium of $753,380 over the asset value of the common stock after the sale of the new issue.[421] Yosemite Holding Corporation agreed to issue to Mr. Groves 282,500 shares of common stock, constituting 43% of the total voting power, for $282,500,[422] at a premium of $132,775 above the asset value of the common stock after the receipt of the proceeds for the new stock.[423]

Each of these companies, at the time Mr. Groves obtained control, had the major part of its funds invested in a portfolio of general diversified securities.[424] As one result of the transfer of control to Mr. Groves, each of the companies underwent a modification of its previous investment policy in being turned into a holding company for the "control" blocks of stock of other companies of little or no asset value. In none of the cases was the general body of common

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[417] See Ch. II of this part of the report, note 37, p. 189, and Public Examination, The Equity Corporation, at 71–2 and 242.

[418] Public Examination, The Equity Corporation, at 81, 86–87, and Commission's Exhibits Nos. 10 and 94.

[419] According to the company's own figures, the common stock of Interstate Equities Corporation had a net asset value of 43 cents a share as of November 13, 1931, or an aggregate net asset value of $276,282.31 for 642,517 shares (id., Commission's Exhibit No. 16). However, on the basis of an independent audit by Payer & Clauson, certified public accountants, the asset value of this common stock was minus 11 cents per share (id., Commission's Exhibit No. 18).

[420] Id., Commission's Exhibits Nos. 8 and 9; and derived from supplementary information supplied the Commission for The Equity Corporation.

[421] Prior to the additional issue, the common stock had no asset value. (Op. cit. supra, note 418, Commission's Exhibit No. 9, and see Ch. II of this part of the report, note 46, p. 191.) Receipt of $2 a share for the new stock brought up the preferred stock to its stipulated liquidating value and gave to the 627,200 shares of common stock which would be outstanding after Mr. Groves met his commitment an asset value of approximately 39 cents per share (derived from supplementary information supplied the Commission for The Equity Corporation). Mr. Groves, in purchasing 467,938 common shares of Chain & General Equities, Inc., at $2 a share, was paying $935,876 for stock which, after payment by him, had an asset value of $182,495.82, or a premium over asset value of about 410%.

[422] Op. cit. supra, note 418, Commission's Exhibits No. 28 (pars. 1 (a) and 2) and No. 185.

[423] The 377,199 common shares of Yosemite Holding Corporation outstanding prior to Mr. Groves' purchase had an asset value of 17 cents per share (id., Commission's Exhibit No. 28). By purchasing 282,500 shares at $1 a share Mr. Groves was adding $282,500 to the assets of Yosemite Holding Corporation. The 659,699 shares outstanding after the purchase possessed a net asset value of 53 cents per share, or an aggregate asset value of $149,725. Mr. Groves also purchased from Baker, Simonds & Co., the co-sponsor of Yosemite Holding Corporation, 254,394 warrants to subscribe to Yosemite stock at 20 cents per warrant for an aggregate of $50,878.80 (id., at 242–5).

[424] Replies to the Commission's questionnaire for Interstate Equities Corporation, Chain & General Equities, Inc., and Yosemite Holding Corporation, Pts. II and III.

stockholders or preferred stockholders informed of the shift in the personnel of the management or the objectives of the company until after the event.[425]

As a second result, these three companies suffered a substantial diminution in their cash and marketable securities.[426]

Both of these results came about through the fact that Mr. Groves, not having the funds to pay for the "control" blocks of stock of the three companies, arranged to have these companies buy each other's stock. He took up the "control" stock of Interstate Equities Corporation with funds borrowed from Franklin Plan Corporation, a holding company for small loan companies in which he had effective influence; [427] borrowed from Interstate Equities Corporation to take up the stock of Chain & General Equities, Inc.; [428] sold his "control" holding of Interstate Equities stock to Chain & General Equities, Inc. to raise money to pay for the Yosemite stock, and to repay the Franklin Plan Corporation loan; [429] and sold one-half of his holdings of Chain & General Equities, Inc. stock to Yosemite Holding Corporation,[430] and the other half to Franklin Plan Corporation to repay his loan from Interstate Equities Corporation.[431] At the conclusion of his transactions with these three investment companies, Mr. Groves, with an original nominal investment, if any, had acquired 292,500 shares of common stock of Yosemite Holding Corporation,[432] which in turn controlled Chain & General Equities, Inc.,[433] which in turn controlled Interstate Equities Corporation.[434]

In each instance the investment company, in order to pay the price of the common stock of the other investment company, was compelled to liquidate all or a substantial part of its portfolio of diversified securities or to hypothecate them for a loan.[435]

In December 1932, the "control" stock of Yosemite Holding Corporation, representing control of Chain & General Equities, Inc. and of Interstate Equities Corporation, was transferred by Mr. Groves to

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[425] See Ch. II of this part of the report, pp. 181–226.

[426] Ibid.

[427] Op. cit. supra, note 418, at 86, 297, 300 and Commission's Exhibit No. 34.

[428] Id., at 118 and Commission's Exhibits Nos. 8 and 11.

[429] Derived from supplementary information supplied the Commission for The Equity Corporation.

[430] Op. cit. supra, note 429, and op. cit. supra, note 424, Commission's Exhibit No. 32. See also discussion in op. cit. supra, note 415.

[431] Op. cit. supra, note 418, at 268, 271, 789, and Commission's Exhibits Nos. 19 and 33. See also discussion in op. cit. supra, note 415.

[432] Op. cit. supra, note 418, Commission's Exhibits Nos. 30 and 185, and derived from supplementary information supplied the Commission for The Equity Corporation. In addition to the 282,500 shares originally purchased by Mr. Groves, he had acquired 10,000 shares from Yosemite Holding Corporation (ibid.).

[433] Op. cit. supra, note 418, Commission's Exhibits Nos. 19, 30, 33, and 219.

[434] Id., Commission's Exhibits Nos. 2, 18, and 19.

[435] Interstate Equities Corporation hypothecated $1,000,000 of "blue chip" securities in its portfolio with The National City Bank of New York in borrowing funds to lend to Mr. Groves for the purchase of control of Chain & General Equities, Inc. (id., at 95 and Commission's Exhibit No. 13). Yosemite Holding Corporation, in order to buy the Chain & General Equities, Inc., common stock from Mr. Groves, was required to liquidate in excess of 90% of its portfolio of diversified securities (id., at 791–800 and Commission's Exhibit No. 28). Chain & General Equities, Inc., liquidated a substantial proportion of its diversified portfolio in the course of acquiring so much of the common stock of Interstate Equities Corporation as constituted 45% of its portfolio (id., at 99–100).

The Equity Corporation.[436] This was a new investment company formed by Wallace Groves and Chase Donaldson with several associates.[437] In exchange for his transfer to The Equity Corporation of control of Yosemite Holding Corporation and its subsidiaries, Mr. Groves received the controlling block of the common stock of The Equity Corporation.[438] This constituted a change in the nominal control of the three holding companies, but no change in the real control, as Mr. Groves himself held the power over the new top holding company, namely, The Equity Corporation.

In the following year, in May 1933, the control of the entire system underwent a real change. Mr. Groves sold his holdings of The Equity Corporation common stock to David Milton and his associates for $1,050,000,[439] or a net profit to Mr. Groves of approximately $985,000.

The severe losses suffered by the preferred stockholders of Yosemite Holding Corporation and Chain & General Equities, Inc. by virtue of Mr. Groves' stewardship is graphically illustrated by the fact that the former, prior to the shift in control to Mr. Groves, had a portfolio of marketable securities of a market value of approximately $400,000,[440] while on December 31, 1933, the company's assets consisted almost exclusively of the common stock of Chain & General Equities, Inc., of the aggregate liquidating value of $3,138.60; [441] the latter company (Chain & General Equities, Inc.) prior to Mr. Groves' accession, had 97% of its assets in a diversified list of marketable securities,[442] whereas by June 30, 1933, only 40% was invested in diversified marketable securities.[443] The bulk of the remaining assets of Chain & General Equities, Inc. was invested in the common stock and preferred stock of Interstate Equities Corporation, which stock possessed little asset value.[444]

Interstate Equities Corporation was the last of this network of investment companies acquired by Mr. Groves to be subjected to a deviation of investment functions and a drain of its assets. The first step in the disintegration of Interstate Equities Corporation constituted an integral part of the plan of the sale of control of The Equity Corporation to the Milton interests. In brief, Interstate Equities Corporation expended approximately $900,000 in cash and liquid securities by being caused to purchase stock of inactive insurance companies from Underwriters Equities, Inc., a company controlled by

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[436] Op. cit. supra, note 418, at 7849–50, 11983–6, 11989–91, and Commission's Exhibits Nos. 766, 831, and 1173.

[437] Id., Commission's Exhibit No. 831.

[438] Op. cit. supra, note 436.

[439] Op. cit. supra, note 418, Commission's Exhibit No. 837.

[440] Id., Commission's Exhibit No. 28.

[441] Id., Commission's Exhibit No. 843, and derived from supplementary information supplied the Commission for The Equity Corporation.

[442] As of September 30, 1931, this company had net assets (at market or estimated fair value) of $1,978,077, of which $1,917,547 was invested in diversified marketable securities (op. cit. supra, note 418, Commission's Exhibit No. 9).

[443] At the end of June 1933 the net assets of Chain & General Equities, Inc., had decreased to $1,272,942 (op. cit. supra, note 418, Commission's Exhibit No. 235–L) of which only $511,858 was invested in diversified marketable securities (ibid.).

[444] This investment, which had cost Chain & General Equities, Inc., the sum of $1,690,986, had an asset value of only $494,827 at June 30, 1933. (Op. cit. supra, note 418, Commission's Exhibits Nos. 235–L and 843.)

David Milton. With the cash thus obtained Mr. Milton paid Mr. Groves the purchase price of The Equity Corporation "control" stock.[445]

c. Absorption of Other Investment Companies by The Equity Corporation

When David Milton assumed control of The Equity Corporation in May 1933 it controlled four subsidiary companies with gross assets of $6,500,000.[446] The major part of the assets was possessed by Interstate Equities Corporation.[447] By December 1935, when its expansion program was completed, the gross assets subject to the control of The Equity Corporation had risen to approximately $205,000,000 by a process of the absorption of the assets of 21 publicly held investment companies.[448] The assets possessed by Interstate Equities Corporation were the initial lever for the expansion of The Equity Corporation.

The first step in the procedure of absorption was the acquisition from the preceding management of the "control" blocks of stock of the companies ultimately to be absorbed.[449] The purchase by The Equity Corporation in June 1933 of the Class A stock of the United Founders Corporation is an excellent illustration of this technique.[450] Thereafter, by the exchange programs, a sufficiently large holding of the securities of the company would be sought to secure a consolidation or merger with The Equity Corporation.[451]

The record of the operations of The Equity Corporation reveals that the feature of the complex capital structure in investment companies, i. e., the existence of a "control" class of stock, made possible the entire development and was the instrumentality by which operators such as Mr. Groves and Mr. Milton accomplished their objectives.

In almost all instances, after The Equity Corporation had acquired working control of the subsidiary through ownership of the "control" block of equity stock, it proceeded to acquire preferred stock of the company, as well as additional equity stock, in order to be able to effect merger or consolidation under the Delaware and Maryland statutes.[452] It is instructive, however, that The Equity Corporation

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[445] Op. cit. supra, note 418, at 7905–6 and Commission's Exhibit No. 718; see opinion of the Securities and Exchange Commission *In the matter of The Equity Corporation* (2 S. E. C. 675 (1937)) rendered in connection with a proceeding to determine whether a stop order should issue, pursuant to Section 8 (d) of the Securities Act of 1933, suspending the effectiveness of a registration statement filed by The Equity Corporation, on the ground that the statement was deficient in respect to certain material matters. For discussion, see Ch. IV of this part of the report, pp. —.

[446] Op. cit. supra, note 418, at 7849–50, 11983–6, 11989–91, and Commission's Exhibits Nos. see Ch. IV of this part of the report.

[447] See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pt. VII, p. 199. See also Ch. IV of this part of the report.

[448] See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pt. VII, pp. 203–5.

[449] Id., at 204 and 211–3.

[450] For details see id., at 213–22.

[451] For detailed discussion of technique employed by The Equity Corporation, see id., at 211 et seq.

[452] Id., at 204 and 211–28.

was enabled to secure its first strategic position of effective control in those companies by virtue of the purchase of the "control" stocks from previous sponsors. Table 31 shows that The Equity Corporation, prior to the first "exchange" offers, had acquired, in most instances, more than 50% of the common (or management) stock, whereas it had acquired very minor holdings, if any, in senior securities.[453]

TABLE 31.—*Comparative holdings by The Equity Corporation of senior and junior securities of various investment companies acquired prior to the first exchange offers*

Name of company and stock	Date of first exchange offer	Shares held shortly prior to original exchange offer	
		Number	Percent of total outstanding
Yosemite Holding Corporation:			
Preferred	Mar. 18, 1933	3	0.04
Common	Mar. 18, 1933	330,532	51.1
Allied General Corporation:			
Preferred	Mar. 18, 1933	16,130	60.8
Class A	Mar. 18, 1933	19,630	54.2
Common	Mar. 18, 1933	125,000	50.8
Chain & General Equities, Inc.:			
Preferred	Mar. 15, 1933	0	0
Common	Mar. 15, 1933	324,607	51.7
Interstate Equities Corporation:			
Preferred	June 8, 1933	6,220	4.3
Common	June 8, 1933	717,617	57.4
Eastern Shares Corporation:			
Preferred	Nov. 14, 1933	0	0
Common	Nov. 14, 1933	100,056	58.9
American Founders Corporation:			
7% preferred	June 23, 1934	2,438	5.8
6% preferred	June 23, 1934	9,105	8.0
Common	Sept. 1, 1934	7,066,164	78.7
American and Continental Corporation:			
Common	July 16, 1934	250,298	59.0
Class A common		12,501	50.0
United Founders Corporation:			
Common	May 20, 1935	500,000	5.5
Class A		666,666⅔	66.7
Reliance International Corporation:			
Preferred		53,917	31.6
Class A	Apr. 20, 1935	332,792	53.4

The ultimate step in the program of The Equity Corporation was the absorption of the assets of the subsidiary companies by dissolution, or merger, or, as occurred in one instance, consolidation of several companies into one subsidiary.[454] The reorganization prescribed by The Equity Corporation effected drastic revisions in the rights and

[453] Id., at 214, 219, 225, and 293. Also see Public Examination, American General Corporation, et al., Commission's Exhibit No. 3405 (p. 110).

[454] For detailed discussion see op. cit. supra, note 448, at 294–336, and also 204. Eight companies were consolidated on November 23, 1935, into a new corporate entity known as American General Corporation. For enumeration of these companies see id., at 310.

privileges of security holders. Thus preferred stockholders who accepted The Equity Corporation exchange offers and agreements of merger or consolidation surrendered securities possessing preferences on liquidation of more than $8,300,000 more than the preferences of the securities received.[455] Similarly, those preferred stockholders whose securities were acquired by The Equity Corporation through exchange offers, merger, or consolidation suffered a loss in net asset value of over $2,400,000.[456]

Large amounts of assets which would have gone to the original preferred stockholders, had their companies been dissolved prior to their yielding to the pressure of The Equity Corporation exchange program, accrued instead to the enrichment of The Equity Corporation. This was made possible, in large measure, by a characteristic of the senior-junior securities set-up, namely, that the common stock possesses the power to prevent dissolution despite the fact that it will have no claim on the company's assets in the event of dissolution.[457] However, due to this recognized impotence of the senior securities to procure liquidation, an entity which has secured possession of the equity securities is frequently able to acquire a substantial part of the senior securities at a price or basis of exchange considerably lower than the asset value. The entity so vested with the common stock "control" is then in a position to obtain the asset value of its holdings of senior securities, a result which the public holders of the senior securities could not accomplish. The program of The Equity Corpo-

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[455] Op. cit. supra, note 418, Commission's Exhibit No. 775. See also op. cit. supra, note 448, Sec. IV, note 25.

[456] Op. cit. supra, note 418, Commission's Exhibits Nos. 767–770, 772–775, 821, 838, 840, and 845–848; see the reply to the Commission's questionnaire for The Equity Corporation, Pt. I (Exhibit J9). See also op. cit. supra, note 448, Sec. IV, note 27.

[457] Carroll E. Gray, Jr., who sold his 40% voting control of Burco, Inc., at a time when the equity stock had no asset value, but when the preferred stock would have been able to realize 100% on liquidation, testified as follows (Public Examination, First Income Trading Corporation et al., at 873–6):

Q. So during the normal course of the history of the corporation or the investment trust, if they have enough money to cover the preferred and have something for the common, then this preference does not mean anything. The only thing this preference means is he is getting less income than the common stockholders.

A. That is correct.

Q. The time that his preferred position is vital is when there is not enough money to pay common stockholders anything; the stockholder becomes concerned, then, as to whether his preference is going to mean anything. Is not that so?

A. That is correct.

Q. That was the situation at the time you carried on the negotiations for the sale of your common stock. Is not that so?

A. Correct.

* * * * * * *

Q. If his preferred stock meant anything at all to him at any time, that is the time it meant something to him.

A. Not any more than any other time.

Q. You do not deny that at that time if there was a liquidation he would get every dollar of the money?

A. That is correct.

Q. And the common stockholder would get nothing?

A. That is correct.

* * * * * * *

Q. [The sponsors who held] almost a majority of the common stock had it in their power either to consent to liquidation or not consent to liquidation and make the assets available to the preferred stock; is not that so?

A. That is correct.

Q. You do not deny, Mr. Gray, that if you decided that you thought the trust should be liquidated at that time that you with your block of stock would have had that trust liquidated and turned the assets over to the preferred?

A. I did not think it should be liquidated at that time or any other time.

Q. I am not saying that. I am just propounding the hypothetical question. Your block of stock would have played a material part in any attempt to liquidate. Is not that so?

A. That is correct.

ration—the securing of "control" equity stocks, the obtaining of preferred stock by exchanges, and the ultimate dissolution or merger of the acquired investment companies—was in essence the utilization to its own advantage of the severance between the prior right to the assets of the company and control of the company generally effected by the multiple-security set-up.

d. Atlas Corporation

The program of Atlas Corporation which involved the acquisition of 21 investment companies was most successful in the case of multiple-security investment companies.[458]

In 1930, Floyd B. Odlum, the dominating influence in Atlas Corporation, realized that the common stocks of leverage investment companies were selling at a market premium above their negative asset value, whereas the preferred stocks of such companies were selling at a market price less than their asset value.[459] Atlas Corporation was thereupon launched on a policy of profiting by the differential between the cost to it of the securities of leverage investment companies acquired and the asset values of the senior securities of these companies.[460]

To secure the right to the assets of the companies to be acquired, Atlas Corporation had to obtain the senior securities, while to achieve the power to reduce the senior securities to their asset value, Atlas Corporation had to acquire the equity securities of the companies.[461] Lester Roth, a director of National Securities Investment Company and an officer of A. G. Becker & Co., Inc., the sponsor from whom

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[458] A more detailed discussion of acquisitions by Atlas Corporation appears in Ch. IV of this part of the report, pp. 1052–71 and p. 1094 et seq.

[459] Public Examination, Atlas Corporation, at 15319.

[460] It should be noted that Atlas Corporation could and did apply this technique to nonleverage companies, as well as to leverage companies, inasmuch as the common stocks of nonleverage companies were selling at a price below asset value. For the controlling common stocks of nonleverage companies Atlas Corporation had to pay a price usually equivalent to or slightly in excess of their asset values, and the sums paid for control bore a relatively high ratio to the total assets of the acquired companies. In the case of leverage investment companies, however, the controlling blocks of common stock had no asset value, so that the sums paid by Atlas Corporation for such stock were in their entirety premium values. But the sums paid for controlling blocks of leverage common stock usually bore a relatively low ratio to the total assets of the acquired leverage investment companies, all of which belonged to their preferred stockholders. Mr. Odlum testified that the bulk of the profit was made from the absorption of leverage companies (Public Examination, Atlas Corporation, at 17828):

> Q. Now, after you got through with your entire campaign, where was the money made, in the preferred or the common?
> A. In the preferred mostly.
> Q. And how much after you got all through with your campaign, did Atlas Corporation make on its exchange program?
> A. I can give you the accurate figures: On its entire program of acquisition of investment trust stocks, Atlas Corporation made before commissions, and before expenses, that were not a part or buried in the cost itself, a gross gain of $16,736,000. That again was made as follows: I mean it is divided between preferred and common: We made $13,601,982 by acquiring preferred stocks and bonds below their par value, or below their asset value, if their asset value was lower than their par value.
> Q. That is, you made that amount of money buying these securities at discount, below asset or below par.
> A. Yes. Now, we made $3,134,621 in the acquisitions below their asset value of common stocks and warrants and other so-called equity stocks. In acquiring those stocks we paid more than similar stocks were selling for in the market.

[461] The common stock or other class of stock which carried the exclusive or major voting power. See supra, p. 1576, for reasons for the noninclusion of preference stocks within the term "equity securities" for the purposes of this chapter.

Atlas Corporation purchased the "control" common stock at a premium, corroborated the general disability of the preferred stockholder to realize the asset value of his stock.[462]

In general, Atlas Corporation proceeded, first, to secure the common stocks which gave it the power to derive asset gains by acquiring the senior securities. In fact, the consummation of the primary objective, the realization of the differential in asset value of the preferred stock, would not have been possible unless control over the common was procured. Floyd B. Odlum, president of the Atlas Corporation, testified:[463]

> At the time of the acquisition program a great many of the leverage type of companies had lost assets until their common stocks were below any value, assetwise, but they all had a market. In other words, the so-called low-price leverage common stocks were selling at a premium. The preferred in the same company were selling at a substantial discount, and, therefore, * * * in order to absorb it and get into the management, it would do no good to go out and buy the preferred and stay there because the common controlled the management and the portfolio, and you could never do anything. We had to, as an incident of the purchase, acquire these common stocks, and in many of them any money we paid for them we were losing asset value.

The necessary equity securities (the "control" stock) Atlas Corporation bought principally from the current sponsors, paying them large premiums,[464] while the senior securities it procured through cash purchases or exchanges at their market price or slightly above.[465] Having obtained a strong equity position in the acquired companies and in some cases the cooperation of the sponsorship to whose advice the public investor was naturally susceptible, Atlas Corporation was in a position to effectuate the acquisition of the senior securities on the terms of its cash or exchange offers. With its holdings of the senior securities, which could be liquidated at a profit, and the equity securities, which had the power to determine such liquidation, Atlas Corporation could proceed to dissolve the acquired company or to merge it with Atlas Corporation, as seemed more feasible.

Of the eight leverage investment companies embraced in the Atlas Corporation acquisition program, control of two was sold by it at a profit; four were dissolved; and two were consolidated with Atlas Corporation in October 1936.[466]

Stockholders, other than sponsors, of companies who sold their shares below asset value to Atlas Corporation directly or to their own

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[462] Public Examination, National Securities Investment Company, at 14410–13.

[463] Op. cit. supra, note 459, at 17831.

[464] In the course of its acquisition program Atlas Corporation expended $21,651,457 in the purchase of "insiders'" leverage and nonleverage securities. This amount was $7,044,544 in excess of the market value and $461,297 in excess of the asset value of the securities acquired (id., Commission's Exhibit No. 1966). In several instances the sponsors exercised control, not by virtue of a holding of equity securities but through management contracts or option warrants or by proxy machinery. (See Ch. IV of this part of the report.) In such instances, Atlas Corporation would seek, by means of various emoluments, to secure the cooperation of the management in acquiring the necessary equity stock outstanding with the public, as well as the senior securities (ibid.).

[465] Public Examination, Atlas Corporation, at 17728, 17773–4, 17828, and Commission's Exhibits Nos. 1962 and 2001.

[466] See Ch. IV of this part of the report.

companies while under the management of Atlas Corporation suffered losses, measured by the difference between the asset value of their shares at the time of sale and the prices which they received for their shares, of approximately $7,365,000.[467] The securities of Atlas Corporation offered in exchange usually had a market value slightly in excess of the market value of the securities of acquired companies which were surrendered in exchange. On the other hand, the Atlas Corporation securities almost invariably had a substantially lower asset value than both the asset and market value of the securities received in exchange. Stockholders of acquired companies who exchanged their shares for securities of Atlas Corporation suffered losses of approximately $12,812,000, measured by the difference, as of the date of exchange, between the asset value of the shares surrendered by the stockholders and the market value of the Atlas Corporation securities received.[468] However, approximately 85% of the gains derived by Atlas Corporation as the result of its expansion program reaccrued to stockholders of the acquired companies who exchanged their securities for Atlas Corporation's securities; only 15% of the gains accrued to the original stockholders of Atlas Corporation.

The assets of the acquired companies were frequently used to acquire control of additional companies.[469] The transfer of control by preceding sponsors to Atlas Corporation resulted almost uniformly in a change of investment policy without prior consultation with or notice to the security holders among the investment public.[470] Sponsors accepted premiums and emoluments and thereafter, in many instances, aided the Atlas Corporation in its program of exchanges and purchases.[471]

A résumé of the patterns of capitalization of several of the acquired companies will indicate how the multiple-security structure, by vesting in the common stock, held largely by the sponsors, the power to control the assets and to prevent the senior security holders from dissolving the company, provided the sponsors with an opportunity to transfer their holdings to others on advantageous terms.

(1) NATIONAL SECURITIES INVESTMENT COMPANY[472]

At the conclusion of the recapitalization in February 1929, A. G. Becker & Co., Inc. and George Pick & Co., Inc., sponsors, had acquired 75% of the common stock, constituting 60% of the outstanding voting shares (the 200,000 shares of preferred stock each had one vote per share), for a capital contribution of $3,125,000,[473] while the public

[467] Op. cit. supra, note 465, Commission's Exhibit No. 1989.

[468] Ibid.

[469] Op. cit. supra, note 466.

[470] Op. cit. supra, note 465, at 18235 and Commission's Exhibit No. 2039.

[471] Id., at 17769–70, 17777, and 17795.

[472] The organization and financing of this company is discussed in greater detail in Ch. IV of this part of the report, pp. 1094–1119.

[473] Public Examination, National Securities Investment Company, at 14274–9 and Commission's Exhibits Nos. 1447, 1449, 1450, 1451, 1452; *Moody's Manual of Investments, Banks, etc.,* 1930, p. 2305. The sponsors had bought 250,000 shares of the common stock from the company at $12.50 a share when the market price ranged between $25 and $28 a share. Hence, the sponsors had a potential profit, based on the market price of the stock, of at least $3,125,000 (ibid., and *Bank and Quotation Record,* December 1929).

had received the preferred stock and 40% of the voting power for a capital contribution of $20,100,000.[474] In September 1931, when the common stock of the National Securities Investment Company had no asset value whatever, A. G. Becker & Co., Inc. recovered, through the sale of its "control" block of common stock to Atlas Corporation, the entire actual cost of its investment in the common stock of National Securities Investment Company.[475]

(2) CHATHAM PHENIX ALLIED CORPORATION [476]

In the capital financing of this company, Chatham Phenix Corporation, the sponsor, obtained the 100,000 shares (100%) of voting common stock by a contribution of $2,500,000 to the capital of the company. The nonvoting common stock was distributed to the public for a capital contribution of $47,500,000.[477] In August 1931 Atlas Corporation, in order to obtain the voting stock, paid the sponsors slightly more than the full asset value of that voting stock as well as the full asset value of 318,368 shares of the nonvoting stock held by the sponsors at that time. The price paid by Atlas Corporation was, moreover, $2,091,840 in excess of the market value of the stock.[478]

Atlas Corporation, having acquired the voting stock through paying a small asset and a large market premium to the sponsors, proceeded with its usual practice of acquiring the nonvoting shares held by the public at a price considerably below the asset value of those shares.[479] Atlas Corporation had expressly stipulated in the contract for the purchase of the sponsors' holdings that the market price of the nonvoting stock was thereafter to be in the sole control of Atlas Corporation.[480]

(3) STERLING SECURITIES CORPORATION [481]

At the conclusion of the financing the original management interests had acquired, for a capital contribution of $124,148.50, an aggregate block of 248,297 shares of the Class B stock at 50 cents a share,[482]

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[474] Public Examination, National Securities Investment Company, at 14274–9 and Commission's Exhibits Nos. 1447, 1449, 1450, 1451, and 1452; *Moody's Manual of Investments, Banks, etc.*, 1930, p. 2305. The net assets of the company at this time amounted to $30,986,721.35. (Public Examination, National Securities Investment Company, Commission's Exhibit No. 1449).

[475] Public Examination, National Securities Investment Company, at 14359.

[476] The organization and financing of this company is discussed in greater detail in Ch. IV of this part of the report. As the voting and nonvoting common stock had equal rights in assets and surplus profits, this was not a "leverage" company. However, it possessed a multiple security capital structure by virtue of the difference in voting rights.

[477] Public Examination, Chatham Phenix Allied Corporation, at 15564 and Commission's Exhibits Nos. 1588, 1589, and 1590.

[478] Id., at 15591–8 and Commission's Exhibits Nos. 1617 and 1618.

[479] Id., at 15991–8.

[480] Id., Commission's Exhibit No. 1617. The contract provided that: "It is to be understood that the market in shares of Chatham Phenix Allied Corporation is to be in our [Atlas] sole control from now on, and to that end your corporation and its affiliates shall not deal further in such shares without our previous consent" (ibid.).

[481] A more detailed discussion of this company has been presented, supra, pp. 1624–31.

[482] Public Examination, Sterling Securities Corporation, at 14642–6, 14661, 14666, 14671, 14690 and Commission's Exhibit No. 2001 (pp. 259–261).

sufficient to secure them the working control of the company,[483] to which the public had made a capital contribution of approximately $32,000,000 for preferred, preference, and Class A stock.[484] By December 31, 1931 Atlas Corporation had purchased at an average price of $4 per share from the various members of the sponsor group 210,708 shares of the Class B stock,[485] which at that time had neither asset value nor quoted market value.[486] To reenforce its voting power, Atlas Corporation also bought from the management interests 86,896 shares of the Class A stock, which had no asset value, at an average price of $5 a share,[487] a price $2 above the market value of these shares.[488]

(4) ATLANTIC SECURITIES CORPORATION

In this company the public held both the preferred stock and the common stock, for which it had made net contributions to the capital of the company of $7,146,903.50.[489] The main sponsors, F. S. Smithers & Co. and A. Iselin & Co., held 18,693 warrants to purchase common stock which they had acquired without cost as management compensation.[490] By April 30, 1932, the net assets of the company had shrunk to $1,927,992.73.[491] The preferred stock, entitled to a liquidating preference in assets of $52.50 a share, had an actual asset value of $37.87 a share. The common stock had no asset value [492] and a market price of $2 a share.[493] The management option warrants had no market quotations; [494] and since they could be converted into common stock only upon the payment of prices ranging from $21 to $35 for each share of common stock,[495] they no longer possessed any immediate value.

Nevertheless, Atlas Corporation paid F. S. Smithers & Co. and A. Iselin & Co. $150,000 in cash for these warrants [496] in consideration for the sponsors' aid in inducing the common and preferred stockholders of Atlantic Securities Corporation to exchange their stock for the stock of Atlas Corporation.[497] Under the terms of the exchange offer a holder of a share of common stock received Atlas Corporation securities of a market value and asset value approximately $1.25 greater than his own share of stock.[498] But the holders of the pre-

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[483] Only 50,000 Class B shares had been issued to the public. See supra, pp. 1624–31.

[484] Op. cit. supra, note 482, at 14662 and 14710–1.

[485] Id., at 14678, 14696, 14763 and Commission's Exhibits Nos. 1506, 1507, and 2001 (p. 265).

[486] Id., Commission's Exhibit No. 2001 (p. 261).

[487] Id., Commission's Exhibit No. 2001 (pp. 263–7).

[488] Ibid.

[489] Public Examination, Atlas Corporation, at 18045. Treating dividends paid out and repurchases as a return of capital, the net contributed capital amounted to $6,237,076.75 (ibid., and see the reply to the Commission's questionnaire for Atlantic Securities Corporation, Pt. II).

[490] Public Examination, Atlas Corporation, Commission's Exhibit No. 1993.

[491] Id., at 18045–54.

[492] Ibid.

[493] Id., Commission's Exhibit No. 1993.

[494] Id., at 18054.

[495] Id., Commission's Exhibit No. 1993 (Exhibits 7, 10, 13a).

[496] Id., Commission's Exhibits Nos. 2001 (p. 142) and 1993 (Exhibit 16).

[497] Id., Commission's Exhibit No. 1992.

[498] Id., Commission's Exhibit No. 2001 (p. 145).

ferred stock which was exchanged received Atlas Corporation securities of both an asset value and market value much below the asset value of their preferred stock.[499] The favorable treatment of the common stock is explained by the desirability of that stock to Atlas Corporation for effecting the dissolution of the company. This is an example of the conflict of interest which may exist between common stock and preferred stock even when both classes are held by the general public. Detachable warrants identical with those purchased by Atlas Corporation from the sponsors were outstanding also in the hands of the public,[500] but Atlas Corporation made no offer for the warrants held by others than the sponsors.

e. Instances of Shifts of Control for Purposes Other Than Absorption Into a System

While The Equity Corporation and the Atlas Corporation were organizations which had large scale programs of acquisition of investment companies, many other financial institutions and individuals also engaged in acquiring control of investment companies, especially after the crash in the securities market in 1929.

The barter in investment companies assumed such large proportions after 1929 that certain individuals ("finders") made a business of contacting sponsors willing to sell control of investment companies and prospective purchasers seeking to buy control of investment companies.

The multiple-security pattern of capitalization, which the major part of the closed-end investment companies had adopted, provided a class of sponsor from whom control could be readily and cheaply acquired. A number of such instances will be outlined.

(1) MONTHLY INCOME SHARES, INC.—DONALD P. KENYON

Monthly Income Shares, Inc., of New York,[501] and Monthly Income Shares, Inc., of New Jersey, were incorporated in 1933 and 1934 under the auspices of Robert E. Lancaster.[502] The nonvoting Class A stock of both corporations had been distributed to the public;[503] all the outstanding Class B stock of the companies had been purchased by Mr. Lancaster and his associates.[504]

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[499] Ibid. The preferred stockholders of Atlantic Securities Corporation were offered the choice of Atlas Corporation preference stock plus a warrant or Atlas Corporation common stock plus a warrant. The first of these alternatives involved a comparative asset loss of $4.54 a share, the other an asset loss of $23.43 a share. Under both of the alternatives the market value of the Atlas Corporation securities offered, while exceeding the market value of the Atlantic Securities Corporation preferred stock, was from $13 to $15 below the asset value of the latter (ibid.).

[500] Id., Commission's Exhibit No. 1993 (Exhibit 3a).

[501] For a detailed discussion of this investment company, see Ch. II of this part of the report, pp. 309–49.

[502] Public Examination, Alpha Shares, Inc., et al., Commission's Exhibits Nos. 3079 (p. 2) and 3081.

[503] Id., Commission's Exhibits Nos. 3079 (p. 2) and 3081; *People, etc.,* v. *Monthly Income Shares, Inc., et al.,* Supreme Court, State of New York, Kings County (consent decree entered May 14, 1935); affidavit of Robert R. Wilson, senior accountant, Bureau of Securities of New York State, Department of Law, submitted in support of bill of complaint, p. 52.

[504] Op. cit. supra, note 502, at 19477, and Commission's Exhibit No. 3079 (p. 4); *People, etc.,* v. *Monthly Income Shares, Inc.,* op. cit. supra, note 503, p. 54.

In February 1936 the assets of the two companies totaled $243,284,[505] an amount insufficient to meet the priorities in assets to which the Class A stockholders were entitled on a dissolution of the corporation.[506] Thus the Class B shares held by Mr. Lancaster and his associates had no asset value whatsoever. On February 14, 1936, Donald P. Kenyon purchased Mr. Lancaster's holdings of the Class B stock of the investment companies for $60,000, thus acquiring control of the investment companies.[507] Mr. Kenyon then proceeded to pledge large parts of the portfolios for personal loans to himself and his associates in violation of the charters of the investment companies,[508] to lend himself and his associates large sums and to cause the issuance by both companies of Class AA stocks subordinate in asset and dividend preference to the existing Class A stocks,[509] although the existing Class A shares were already "under water."[510] The newly created Class AA stock was, of course, without asset value.[511] The money received for the sale of this Class AA stock was not turned over by Mr. Kenyon to the investment companies.[512] Thus, by June 30, 1936, five months after Mr. Kenyon had acquired control of the companies, the total assets of Monthly Income Shares, Inc., of New Jersey, were $171,553,[513] of which $122,225 represented the indebtedness to the corporation of Mr. Kenyon and his associates,[514] while the total assets of Monthly Income Shares, Inc., of New York, were $225,836,[515] of which $187,616.83 consisted of indebtedness due from Mr. Kenyon and his associates.[516]

In September and October 1936 both companies were judicially restrained under the Blue Sky laws of New York and New Jersey, and shortly thereafter both companies were placed in receivership for liquidation.[517]

Robert E. Lancaster, who transferred control to Donald P. Kenyon for $60,000, took no steps to inform the public or the holders of the Class A stock of these companies of the shift in control nor to protect their interests in any manner.[518] In fact, even after his sale of his

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[505] Op. cit. supra, note 502, Commission's Exhibit No. 3083; *Hearings In the Matter of Donald P. Kenyon, Clark R. Kenyon, Norman E. Dizer, George Grantham, Edwin Embree, Harry Pasternak, Kenyon & Company, Incorporated,* held on April 28, 1937, pursuant to order for investigation dated April 28, 1937, under Sec. 19 and Sec. 20 (a) of the Securities Act of 1933, pp. 229–30, and Commission's Exhibits Nos. 72, 73, 74, and 75.

[506] According to the charters of each of these companies, the Class A stock was entitled upon liquidation to $1 a share (op. cit. supra, note 502, Commission's Exhibits Nos. 3079 and 3081).

[507] Id., Commission's Exhibits Nos. 3079 (p. 7) and 3149. In consideration for the $60,000, Mr. Lancaster transferred to Mr. Kenyon also all of the common stock of Lancaster, Havens & O'Brien, Inc., and of National Associated Dealers, Inc., two distributing organizations controlled by Mr. Lancaster, the common stock of which had no asset value (ibid.).

[508] Id., at 19601–2, 19738, and Commission's Exhibit No. 3087; *People, etc.,* v. *Monthly Income Shares, Inc., et al.,* op. cit. supra, note 503, Exhibit A, p. 19.

[509] Op. cit. supra, note 502, at 20003 et seq., and Commission's Exhibits Nos. 3081 and 3082.

[510] Id., at 19501–2.

[511] Ibid.

[512] Id., at 19608–11, 19460, and Commission's Exhibits Nos. 3075 and 3076.

[513] Id., Commission's Exhibit No. 3083.

[514] Ibid.

[515] Id., Commission's Exhibit No. 3162.

[516] Ibid.

[517] Id., at 19823, 19993, and see op. cit. supra, note 501.

[518] See Ch. IV of this part of the report, pp. 1157–61.

Class B stock, he continued to distribute the Class A stock of the companies until June 30, 1936, when, due to the refusal of Mr. Kenyon to supply him with financial statements of the companies, Mr. Lancaster cancelled his distribution arrangement with the Corporation.[519]

(2) OILS & INDUSTRIES, INC. (OIL SHARES INCORPORATED)—WATSON, ET AL.

Oils & Industries, Inc., incorporated in Maryland on February 18, 1928, as Oil Shares Incorporated,[520] underwent three complete changes of management. The investment company was originally sponsored by Pettigrew and Meyer, Inc.,[521] which completely controlled the company through a management contract[522] and up to September 1931 had derived large profits from selling commissions, commissions on the redemption of the company's securities and from management fees.[523] The company's capitalization consisted of preferred and common stock distributed in indivisible units.[524]

By September 1931, the net capital of $6,096,000 contributed to the company had depreciated to $1,200,000.[525] The commissions and profits accruing to the sponsor had been steadily decreasing.[526] On September 25, 1931, the board of directors of Oil Shares Incorporated, under the influence of Pettigrew and Meyer, Inc., approved the sale to Holman, Rapp & Co., a Philadelphia investment banking firm, of 10,000 units of the investment company's securities[527] and the sale by Pettigrew and Meyer, Inc. of the stock of Petroleum Research

[519] Op. cit. supra, note 502, Commission's Exhibit No. 3079.

Robert E. Lancaster, at March 1, 1939, was serving a sentence in San Quentin prison for a fraudulent securities transaction of which he had been convicted and sentenced in 1928 under the name of Martin Leach. (Derived from supplementary information supplied the Commission for Investors Fund of America, Inc.)

In connection with transactions with this investment company and others controlled by Donald P. Kenyon and his associates, E. Fairbanks Chase, Norman E. Dizer, Lucian A. Eddy, Edward E. Embree, George R. Grantham, Charles Russell Kenyon, Ernest K. Schwartz, Samuel Sobel, and Stanley R. Wayne, alias Weinstein, were indicted by the Federal Grand Jury for the Southern District of New York on March 30, 1939, for using the mails to defraud, conspiracy to commit fraud, and violating the fraud provisions of the Securities Act of 1933. Donald P. Kenyon, the dominating figure in virtually all of the transactions, was not indicted because he had died in December 1938.

On November 22, 1939, Charles Russell Kenyon, Mr. Grantham, and Mr. Dizer pleaded guilty to the indictments; Mr. Sobel and Mr. Eddy were convicted of the Securities Act charge, mail fraud, and conspiracy; Mr. Embree was found guilty of violation of the Securities Act and conspiracy; and Mr. Schwartz was found guilty of conspiracy to commit fraud. At December 1, 1939, Mr. Wayne and Mr. Chase had not been tried, the indictment as to them having been severed for separate trial. (For a more detailed discussion of this matter, see Ch. II of this part of the report, pp. 309–49.)

[520] Public Examination, Oils & Industries, Inc., at 14115, and Commission's Exhibit No. 1425.

[521] Ibid.

[522] Id., at 14131–2, and Commission's Exhibit No. 1435.

[523] Id., at 14142–5 and 14152.

[524] Id., Commission's Exhibit No. 1427.

[525] Id., Commission's Exhibit No. 1441. The company had returned to its stockholders by way of dividends, repurchases, and redemptions of its own securities $7,104,000 of the $13,200,000 (net proceeds) originally contributed by the stockholders (reply to the Commission's questionnaire for Oil & Industries, Inc., Pt. II, Schedule 20, and op. cit. supra, note 520, Commission's Exhibit No. 1437).

[526] See Ch. II of this part of the report, pp. 94–115; and op. cit. supra, note 520, at 14142–4.

[527] Op. cit. supra, note 520, at 14189.

Corporation,[528] in whose name the management contract with the investment company stood. Pettigrew and Meyer, Inc. claimed that it did not know that the real principals in the transaction were Thomas H. Watson, Montifiore O. Kahn, and Joseph Herzberg, three adventurers in the investment company field [529] who were without substantial funds,[530] and that Holman, Rapp & Co. had been misinformed of the nature of its clients, believing them to constitute a syndicate which had "made a large sum of money running into millions of dollars through operating in real estate in New York City." [531]

Messrs. Watson, Kahn, and Herzberg did not possess the $312,000 necessary to effect the shift in control of Oil Shares Incorporated to themselves.[532] They raised that sum by converting assets of the company to their own use.[533] Civil and criminal proceedings were instituted against Messrs. Watson, Kahn, and Herzberg for the defalcations attributed to them.

This first transfer of control illustrates the common practice of a failure to inform stockholders of a prospective shift in control and the comparative ease with which the liquid assets of investment companies can be appropriated by conscienceless sponsors.[534]

After elimination of the Watson, Kahn, and Herzberg group upon the discovery of their frauds, the company was managed by its former president and old board of directors.[535] In May 1932 Arthur S. Kleeman, president and largest stockholder of Home and Foreign Securities Corporation, formed by Kleeman in 1929, was requested by the directors to take over the management of Oils & Industries, Inc., the new name adopted for Oil Shares Incorporated.[536] The company was, in effect, a single security company since the preferred and common stock had been issued in indivisible units. In fact, within several months of taking over control Mr. Kleeman caused the replacement of the indivisible units by shares of common stock only.[537] Due to the precarious financial condition of the company at this time, the new management acquired its status without owning any stock of the company.[538] While Mr. Kleeman was able to secure his position of influence in the company without the aid of any features of capital structure, he found it necessary subsequently to engraft a multiple-security capital pattern upon the company in order to preserve his control.

By June 1934 Mr. Kleeman found his management control of Oils & Industries, Inc. threatened by David Milton, president of The

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[528] Id., at 14191.

[529] Id., Commission's Exhibit No. 1439 (pp. 4–5, 13–14, and 17).

[530] Id., Commission's Exhibit No. 1444.

[531] Id., Commission's Exhibit No. 1439 (p. 2). For complete details, see Ch. II of this part of the report, pp. 94–115.

[532] See Ch. II of this part of the report, pp. 94–115.

[533] The manner in which the conversions and looting of funds were perpetrated is described in detail, op. cit. supra, note 532.

[534] Ibid. See also *Oil Shares, Inc.*, v. *Kahn et al.*, 94 F. (2d) 751 (C. C. A. 3d, 1938), and op. cit. supra, note 520, at 14224–7 and 14254–7.

[535] Op. cit. supra, note 532.

[536] Public Examination, Home and Foreign Securities Corporation, at 14791, 14822, and 14837.

[537] Id., Commission's Exhibit No. 1442 (Item 4). The outstanding 82,940 indivisible units of preferred stock and common stock were reclassified into 82,940 shares of common stock.

[538] Id., at 14822–3.

Equity Corporation, who had caused Group Assets, Inc., a subsidiary of The Equity Corporation, to acquire approximately 40% of the outstanding stock of Oils & Industries, Inc. Mr. Kleeman was himself responsible for Mr. Milton's stock-ownership position as he had induced Mr. Milton to buy out a group of Canadian stockholders hostile to Mr. Kleeman.[539] Mr. Kleeman had not, however, anticipated that Mr. Milton planned to merge Oils & Industries, Inc. with The Equity Corporation.[540]

As protection against the threat of the Milton "control," Mr. Kleeman had his investment company, Home and Foreign Securities Corporation, purchase the 25,000 shares of stock of Oil Shares Incorporated, held by the Milton interests, at a total cost of $535,250.[541] To finance the purchase, Home and Foreign Securities Corporation was compelled to contract a bank loan of $360,000.[542] To effectuate a plan whereby the assets of Oil Shares Incorporated would be used to repay the debt of Home and Foreign Securities Corporation to the bank, Mr. Kleeman changed the capital structure of Oil Shares Incorporated, from the simple to the complex form. Mr. Kleeman secured an amendment to the charter of Oil Shares Incorporated, pursuant to which the company distributed as a stock dividend to each share of the outstanding common stock, one share of a new issue of $1.00 par value participating preferred stock entitled to a preference in assets to the extent of $12.50 a share on any dissolution of the company.[543] Another amendment canceled the redemption privilege of the common stock, authorized instead the redemption of the new preferred stock at 95% of its liquidating value in underlying assets, in lots of 1,000 shares only, and limited this redemption privilege to a period of three weeks after issuance.[544] The Kleeman interests were the only ones in a practical position to turn in as many as 1,000 shares of preferred stock within the time allowed.[545]

Under these provisions, Home and Foreign Securities Corporation at once turned in 24,000 shares[546] of the Oils & Industries, Inc. new preferred stock which it had received as a stock dividend and obtained therefor portfolio securities of Oils & Industries, Inc.[547] Home and Foreign Securities Corporation, having sold these securities and applied the proceeds in the amount of $286,000 to the reduction of the bank loan, still had left the 24,000 shares of the common stock of Oils & Industries, Inc.[548]

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[539] Id., at 14823–7.

[540] Id., at 14825–8, and Commission's Exhibit No. 1442.

[541] Op. cit. supra, note 520, Commission's Exhibit No. 1442; and op. cit. supra, note 536, at 14835, 14851, and 14854. The price paid was $21.41 a share, a premium of $1.53 a share above the asset value of $19.88 a share (op. cit. supra, note 536, at 14851–4). No active market for the Oil Shares Incorporated stock existed. The shares carried the right of liquidation at 95% of their asset value. (See Ch. II of this part of the report, note 106, pp. 110.)

[542] Op. cit. supra, note 536, at 14836–7.

[543] Op. cit. supra, note 520, Commission's Exhibit No. 1442 (Item 7).

[544] Op. cit. supra, note 536, at 14843.

[545] Op. cit. supra, note 532.

[546] Home and Foreign Securities Corporation had redeemed 1,000 shares of its 25,000 shares of common stock under the previous provision for redemption (op. cit. supra, note 536, at 14852).

[547] Id., at 14846.

[548] Id., at 14837–8 and 14846.

Thus, by converting the company into one with a multiple-security set-up and effecting a preferential redemption, Mr. Kleeman succeeded in extracting the major part of the investment of Home and Foreign Securities Corporation in the stock of the company while preserving intact its voting control in the company. On the other hand, Oils & Industries, Inc. suffered a reduction of net worth, and the stockholders, other than Home and Foreign Securities Corporation, suffered a partial change from an equity to a senior position.[549]

It will be noted that four different groups governed the management of Oil Shares Incorporated, from 1928 to 1935. Yet the rank and file of the stockholders were given no opportunity to be heard in the selection of the managers. The initial actual managers of the company, Pettigrew and Meyer, Inc., were unknown to the stockholders, as the management contract was executed in the name of Petroleum Research Corporation. The shifting of the control of the company to Watson, Kahn, and Herzberg occurred without the consent of the stockholders. These stockholders were not consulted in the selection of Mr. Kleeman and his associates as the managers, nor in the election of the appointees of the Milton interests to the directorate. They were not in a position to resist effectively the transformation of the company from a simple to a multiple-security form of capitalization nor to realize that Mr. Kleeman, by inducing this change, was seeking an end not attainable through the simple-security structure.[550] While each of the controlling groups profited directly or indirectly by its association with the company, the company itself, by December 31, 1935, had suffered realized and unrealized losses of approximately $4,000,000.[551]

(3) ATLANTIC AND PACIFIC INTERNATIONAL CORPORATION—MORRIS PLAN CORPORATION—MERTON ASSETS CORPORATION

Atlantic and Pacific International Corporation was an investment company with a multiple-security capital structure, organized in April 1928 in Maryland.[552] In December 1931, Gero von S. Gaevernitz and Donald J. Hardenbrook were vice president and president, respectively, of Atlantic and Pacific International Corporation[553] and in control of the company by virtue of the ownership of the Class B stock of Atlantic and Pacific International Corporation by United States Share Corporation, an instrumentality of the Gaevernitz-Hardenbrook interests.[554] The preferred stock and the Class A common stock of the investment company had been distributed among the general investing public.[555] By December 1931 the operating losses of the company totaled $2,290,254.08.[556] and the Class B stock had no asset value.[557]

[549] See discussion in op. cit. supra, note 532.

[550] Ibid.

[551] Id., note 123, p. 115.

[552] For a more detailed discussion of this company and the transfer of its control see Ch. IV of this part of the report, pp. 1120–37.

[553] Public Examination, The Equity Corporation, Commission's Exhibit No. 727.

[554] Id., at 8068, 8070, and Commission's Exhibits Nos. 727, 734; *Moody's Manual of Investments, Banks, etc.*, 1932, pp. 1590, 2791, and 2794–6.

[555] Op. cit. supra, note 553, at 8078–9 and Commission's Exhibit No. 729; *Moody's Manual of Investments, Banks, etc.*, 1929, p. 2831.

[556] Op. cit. supra, note 553.

[557] Ibid., and *Moody's Manual of Investments, Banks, etc.*, 1932, p. 1591.

The Morris Plan Corporation, an organization conducting an extensive industrial banking system, whose notes were at the time selling at a 50% discount on their face value, apparently lacked the cash to meet maturing notes and debentures in the face amounts of $1,082,500.[558] John Speed Elliott, a "finder" of investment companies, apprised the Morris Plan Corporation of the potentialities, as a source of cash, of the Atlantic and Pacific International Corporation, which had $1,950,000 in cash.[559] Arthur F. Morris, president of the Morris Plan Corporation, devised a plan to tap that source of cash by selling to Atlantic and Pacific International Corporation the securities of Morris Plan Corporation to the extent of $1,950,000.[560]

To effectuate this purchase on the part of the Atlantic and Pacific International Corporation, the Morris Plan Corporation had to have the support of two-thirds of the preferred stock, Class A common stock, and Class B common stock in securing the elimination from the charter of Atlantic and Pacific Securities Corporation of a provision forbidding the investment of more than 25% of the corporation's funds in the securities of banking institutions or investment organizations.[561]

The cooperation of the Class B stock, controlled by the Gaevernitz group, was procured by an agreement to purchase at a price of approximately $250,000 certain nonmarketable "frozen" assets owned by United States Shares Corporation and by Atlantic and Pacific International Corporation.[562] With the cooperation of the management of Atlantic and Pacific International Corporation, consisting of the Gaevernitz-Hardenbrook group, the Morris Plan Corporation succeeded in acquiring 67% of the outstanding preferred stock and 7% of the outstanding Class A stock through an exchange offer and, to a minor degree, by direct purchases of those stocks.[563]

A "Protective Committee" of preferred stockholders of Atlantic and Pacific International Corporation, which had been formed, opposed the charter amendment upon the ground that the market value of the Morris Plan Corporation securities offered for the Atlantic and Pacific International Corporation preference stock did not exceed $18, whereas the latter had an asset value on dissolution of $40 a share,[564] but this opposition failed to prevent the Morris Plan Corporation from acquiring the amount of preferred and Class A stock necessary for the amendment to the charter. Nevertheless, an action instituted by the Protective Committee resulted in the intimation by a Maryland court that Atlantic and Pacific International Corporation and its management might be enjoined from effecting the proposed charter amendment.[565]

Thus, the Morris Plan Corporation, though now holding two-thirds of the preferred stock and two-thirds of the Class A stock, found access to the cash of Atlantic and Pacific International Corporation, by means

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[558] Op. cit. supra, note 553, Commission's Exhibit No. 728.

[559] Id., at 8120 and Commission's Exhibit No. 727.

[560] Id., at 8080.

[561] Id., at 8080 and Commission's Exhibit No. 729. All the outstanding securities of Atlantic and Pacific International Corporation then had voting rights because of a default in payment of 4 consecutive dividends (*Moody's Manual of Investments, Banks, etc.*, 1932, p. 1571).

[562] Op. cit. supra, note 553, at 8125 and Commission's Exhibit No. 728.

[563] Id., at 8124–6 and Commission's Exhibits Nos. 728 and 733.

[564] Id., at 8085–7 and Commission's Exhibits Nos. 726 and 737.

[565] Id., at 8090 and Commission's Exhibit No. 730.

of a sale of Morris Plan Corporation securities, impeded by the unfavorable attitude of the court. Morris Plan Corporation found achievement of the goal through a liquidation of Atlantic and Pacific International Corporation [566] further blocked by new demands on the part of the Gaevernitz-Hardenbrook group as the price of their cooperation.[567] Mr. Morris, president of the Morris Plan Corporation, then placed the situation in the hands of his attorney, Ellery C. Huntington,[568] who with the aid of his partner, David M. Milton, proceeded to assist the Morris Plan Corporation in its objective.[569]

Mr. Milton and Mr. Huntington, in June 1932, organized in Canada a corporation which they called "Merton Assets Corporation." [570] This corporation agreed to buy from Mr. Gaevernitz and his associates for approximately $335,935 their Class A stock of United States Shares Corporation [571] which, it will be remembered, held the Class B stock of Atlantic and Pacific International Corporation.[572] Merton Assets Corporation at about the same time agreed to purchase all of the preferred and Class A stock of Atlantic and Pacific International Corporation held by Morris Plan Corporation.[573] The price to be paid the Morris Plan Corporation amounted approximately to $40 for each share of the preferred stock of Atlantic and Pacific Corporation (total $1,145,000) and represented the approximate liquidating value of that stock.[574] The receipt by the Morris Plan Corporation of the cash consideration for its holdings of Atlantic and Pacific International Corporation securities would naturally solve the Morris Plan Corporation's problem of cash, but Merton Assets Corporation, the purchaser, was a dummy corporation [575] which did not have cash either to pay the Morris Plan Corporation or to pay Mr. Gaevernitz and his associates. However, Merton Assets Corporation, now in full control of Atlantic and Pacific International Corporation, proceeded at once to borrow from Atlantic and Pacific International Corporation $1,480,935 without putting up any security or collateral.[576] Of this sum, $1,145,000 was immediately turned over to the Morris Plan Corporation in payment for the preferred and Class A stock of the Atlantic and Pacific International Corporation, and $335,000 to Mr. Gaevernitz and his associates for the Class A stock of United States Shares Corporation which they had surrendered to Merton Assets Corporation.[577]

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[566] Id., at 8126 and 8135.

[567] Id., at 8126–7 and 8133–5. Gero von S. Gaevernitz through United States Shares Corporation owned in excess of two-thirds of the Class B stock of Atlantic and Pacific International Corporation which stock would have been entitled to none of the assets of the company had it been liquidated. (See Ch. IV of this part of the report, pp. 1120–37.)

[568] Op. cit. supra, note 551, at 8135.

[569] Id., at 8101.

[570] Id., at 8103.

[571] Id., at 8104 and 8138.

[572] See supra, p. 1661.

[573] Op. cit. supra, note 551, at 8136, and Commission's Exhibits Nos. 733 and 737.

[574] Ibid. It should be recalled that the Protective Committee had pointed out at the time of the offer of the exchange that Morris Plan Corporation was offering securities of a market value of $18 in exchange for the preferred stock of Atlantic and Pacific International Corporation of a liquidating value of $40. (See supra, p. 1662.)

[575] Op. cit. supra, note 553, at 8104.

[576] Id., at 8103–8 and 8115.

[577] Id., at 8138. See also Ch. IV of this part of the report, pp. 1120–37.

The indebtedness of $1,500,000 owed by Merton Assets Corporation to Atlantic and Pacific International Corporation was thereafter eliminated by a series of re-shuffles of the stock of Underwriters Equities, Inc., a holding company controlled by the Morris-Milton group.[578] At the close of the series of artificial sales and exchanges [579] of the stock of Underwriters Equities, Inc., Atlantic and Pacific International Corporation owned a substantial amount of the Class A stock of Underwriters Equities, Inc., and had retired all but approximately 3,000 shares of its preferred stocks.[580] In addition, the indebtedness of Merton Assets Corporation to Atlantic and Pacific International Corporation had been eliminated.[581]

Through this expedient the Morris-Gaevernitz-Milton groups had managed to achieve substantially their original purpose. The Morris Plan Corporation had obtained the bulk of Atlantic and Pacific International Corporation's cash and Mr. Gaevernitz and Mr. Hardenbrook and their associates had obtained their reward or premium.

The "liquidation" accomplished by Mr. Milton resulted in discrimination in the treatment accorded the holders of the several types of securities of Atlantic and Pacific International Corporation.[582] The Gaevernitz group received $335,000 for the Class B shares of Atlantic and Pacific International Corporation held by the United States Shares Corporation, whereas on a statutory liquidation of the corporation the Class B shares would have been entitled to none of the corporate assets.[583] The preferred stockholder who exchanged his stock having a liquidation value of $40 a share for the stock of Morris Plan Corporation suffered large losses.[584] As a by-product of the transaction, Mr. Milton had acquired control of Atlantic and Pacific International Corporation without the expenditure of any of his own funds.[585]

The attrition of the assets of Atlantic and Pacific International Corporation by these intricate maneuvers was made possible by the potent position of the Gaevernitz group as the holders of the assetless Class B stock of the company and the ability of the holders of that Class B stock to transfer or to facilitate the transfer of the control of the company.

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578 The details of the several sales of the stock of Underwriters Equities, Inc., to Atlantic and Pacific International Corporation and the repeated reconveyances of this stock to Merton Assets Corporation, in exchange for the preferred stock of Atlantic and Pacific International Corporation, may be found in Ch. IV of this part of the report, pp. 1120–37.

579 Op. cit. supra, note 553, at 8113.

580 *Moody's Manual of Investments, Banks, etc.,* 1935, p. 1030.

581 Derived from supplementary information supplied the Commission for The Equity Corporation.

582 Op. cit. supra, note. 553, at 8064–5.

583 Id., at 8138. See also Ch. IV of this part of the report, pp. 1120–37.

584 The minority preferred stockholders who resisted the Morris Plan Corporation exchange offers escaped the losses suffered by the preferred stockholders who accepted the exchange offer. (See supra; see also op. cit. supra; note 553, at 8156 and Commission's Exhibits Nos. 733 and 737.) On January 8, 1936, when the Atlantic and Pacific International Corporation was formally liquidated, the outstanding 3,082 shares of preferred stock were liquidated at $44.78 a share (op. cit. supra, note 553, at 8115–6 and *Poor's Banks, etc.,* 1936, p. 2646).

585 Op. cit. supra, note 553, at 8138.

C. Disadvantages to the General Investor Inherent in the Typical Multiple-Security Company Set-up

The illustrations heretofore presented [586] of the initial advantages which accrue to the sponsor by virtue of the multiple-security structure may already have suggested to the reader some of the corresponding inherent disadvantages which that set-up imposes upon the general investor.

The showing that the proceeds to the multiple-security investment company of the sale of equity securities generally constitute a relatively minor part of the total investment in the company establishes at the same time the proposition that the cushion protecting the senior security holder from loss is comparatively thin. The power of control secured by the sponsor, considered in the light of the small investment risks by him and the possibility of a disproportionately large share of the profits being acquired by him, naturally suggests that the sponsor may tend to use that power to direct the company into highly speculative investment channels. Again, reflection upon the degree of familiarity with financial operation and technique required to follow the implications of even the simpler forms of the multiple-security set-up outlined leads to the realization that only an investor with uncommon technical expertness might hope to appreciate the intrinsic values of the various types of securities or the significance of the capital rearrangements in the more intricate capital structure company.

In the immediately succeeding pages a fuller presentation, accompanied by concrete illustrations, will be made of the disadvantages which the multiple-security set-up, by its organic attributes, holds for the general investor.[587]

1. ORIGINAL INADEQUACY OF ASSET COVERAGE FOR THE SENIOR SECURITIES [588]

The corollary to the acquisition by the sponsor of the equity stock (or a substantial part thereof) for a small proportion of the total investment in the company, is an original inadequacy of asset coverage for the senior securities. In case of a liquidation or a dissolution of the company or of any final distribution of the assets, the senior securities (bonded indebtedness and preference stocks) are generally entitled to receive their full face or specified liquidation value before the equity securities are entitled to receive anything. Hence, the amount paid in for the equity securities constitutes a cushion for the senior securities in the sense that the company can sustain a loss in assets equivalent to that amount without impairing the liquidation values of the senior securities. This margin of insulation from loss is the chief virtue claimed for the senior securities. Moreover, the

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[586] See supra, pp. 1596–1664.

[587] See also supra, pp. 1576–93.

[588] The inequities suffered by the investors from transfers of control have already been noted above in the course of the discussion of the advantages thereof to the sponsors. See supra, pp. 1641–64.

fact that the money paid in for the equity securities serves as a cushion or protection for the senior securities has been urged by sponsors and promoters as the justification for the power of control and the right to surplus profits secured by the sponsor through holding the equity securities.

Both Clarence Dillon and Ernest B. Tracy, partners in Dillon, Read & Co., which contributed $5,000,000 (amounting to 20% of the total capitalization) for the second preferred stock and 75% of the common stock of United States & Foreign Securities Corporation, strongly urged that point of view. Mr. Tracy testified: [589]

> In substance what they did, the junior money which took the greater risk, took three-fourths of the common and the senior money, which took less risk, got 25% of the common. This is in substance what the deal was * * *. They (the sponsors) take far the greater risk and they are entitled to a greater percentage of the profits.

Mr. Dillon stressed the function of the "junior money" as a cushion for the "senior money." [590]

> Our idea in putting in this junior money was—well, it was a cushion for the First Preferred, this 20 percent which you do not value as greatly as we did. But the other thing is it insures management, and this company, having that set-up, if you please we think is the cardinal thing in its unusual success, because that junior money insured a management which had real money at risk. That management, in any errors, would lose its own money, $5,000,000, first.

In many instances the paid-in equity or the "junior" money advanced by the sponsors has been inadequate to protect the senior securities from capital impairment. The margin of protection for senior securities was narrow from the very inception of the companies in a great many cases even when money contributed by sponsors for the purchase of second preferred stocks, preferred stocks, and junior debentures—in reality senior securities—is considered "junior" money. Thus the original coverage—the extent to which the entire contributed capital at inception, both "senior" and "junior" money, covered the liquidating value of the securities issued for the "senior" money and provided a further margin or cushion of protection for these securities—was in United States and Foreign Securities Corporation no more than 120%, or a cushion of 20%; [591] in Shawmut Bank Investment Trust, 120%, or a cushion of 20%: [592] in National Investors Corporation, 110%, or a cushion of 10%; [593] in General American In-

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[589] Public Examination, United States & Foreign Securities Corporation, at 11722, 11747.

[590] Id., at 11782.

[591] In the case of United States & Foreign Securities Corporation, approximately $25,000,000 was paid in by the public for the first preferred stock, treated herein as the "senior" money, while $5,100,000 was paid in for the second preferred stock and common stock of the company by the sponsors, considered herein as the "junior" money. See supra, pp. 1598–1602.

[592] The junior debentures issued to the sponsors for their contribution to the capital is here included as "junior money." The percentages given thus represent the coverage and cushion for the senior debentures. The junior debentures had no cushion whatsoever at inception of the company. See supra, pp. 1618–19.

[593] See supra, pp. 1608–14.

vestors Company, Inc., 124%, or a cushion of 24%; [594] in American, British & Continental Corporation, 140%, or a cushion of 40%; [595] in Sterling Securities Corporation, 129%, or a cushion of 29%; [596] in Reynolds Investing Company, Inc., 116%, or a cushion of 16%; [597] the companies in the Pacific Investing Corporation group, to wit: Pacific Investing Corporation, The Investment Company of America, and American Capital Corporation 101.6%, 128%, and 104%, respectively.[598]

It will be seen that on the whole the margin of protection provided the senior securities by the paid-in "junior money" has been very slender—a margin particularly thin, in view of the predilection of the investment companies for common stocks in their portfolios [599] which rendered the market value of the portfolio and hence the assets of the company subject to sharp fluctuations. The Standard Statistics Company index of 90 stocks fell as much as 10% in a six-weeks' period in 1926, a year of fairly stable security prices. This index may be considered representative of the fluctuation in the value of the common-stock portfolio of the average investment company and indicates the changes to which the market value of such holdings may be subject within a short period. In 1929 the Standard Statistics Company index of 90 stocks declined 44% during a period of three months. In view of this degree of variability in the value of the assets of investment companies, a cushion such as was supplied in the companies cited above constituted a very inadequate protection. A drop of 16⅔% in the general market level of portfolio securities would be sufficient to wipe out a 20% cushion and impair the capital of the senior securities of most of the above companies.

As a matter of fact, the coverage supplied the "senior money" by the contribution of "junior money" to capital failed markedly to insulate the senior securities from impairment. A consolidation of the balance sheets of 25 closed-end management investment companies proper having funded debt reveals that in the aggregate no common stock equity existed at the year-ends 1931 and 1932; [600] that in the case of 17 of those companies which had both a funded debt and preferred stock, there was a net aggregate impairment of preferred stock capital to the extent of 5.4% at the end of 1931 and of 16.9% at the 1932 year-end.[601] In actual dollar amounts the statistics show that the 17 companies were $7,900,000 short of meeting the

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[594] The 6% preferred stock issued to the sponsors at the inception of the company is included as "junior" money. The percentages given thus represent the coverage and cushion for the debentures. The cushion for the preferred stock at inception consisted only of the $300,000 paid in for common stock, or a coverage of 103%. See supra, pp. 1603–7.

[595] The second preferred stock issued to the sponsors for their contribution to the capital is here computed as "junior money." The percentages given thus represent the coverage and cushion for the first preferred stock. The second preferred at inception had no cushion whatsoever. See supra, pp. 1615–17.

[596] See supra, pp. 1624–31.

[597] See Appendix I, p. 1937.

[598] The Class A stock of American Capital Corporation since it possessed a fixed limited priority to dividends and to distribution on liquidation is included in the category of senior securities in arriving at the specified coverage figure. The preferred stock of this company at inception had a coverage of 132%, or a cushion of 32%. See Appendix I, p. 1939.

[599] See Pt. Two (House Doc. No. 70, 76th Cong.), pp. 552–6.

[600] Pt. Two, Ch. II, Table 35. The aggregate common stock equity for all companies is given in this table, the negative values of some companies being combined algebraically with the positive values of other companies.

[601] Pt. Two, Ch. II, Table 36.

$81,600,000 of aggregate liquidation claims (including unpaid cumulative dividends) of the preferred stocks at the 1931 year-end, and $21,900,000 short of the $81,000,000 of preferred claims at the year-end of 1932.[602] After 1932 the common stock reacquired an aggregate positive equity value, but nevertheless at no time did the aggregate common stock asset value equal 50% of the liquidation claims of the senior securities. Had it not been for substantial repurchases by investment companies of their senior securities below their claims in liquidation, the coverage of these senior securities would have been materially less at the designated dates.[603]

The equity or "junior money" advanced by "insiders" proved largely insufficient to provide adequate coverage for even the bond issues of management investment companies proper, which are presumed to constitute the most securely protected class of security issues. An analysis of 22 funded debt issues of investment companies shows that from 1931 to 1934 between 3 and 7 issues were "under water" at each year-end.[604] Of the 22 bond issues, 7 were "under water" at least at one year-end from 1927 to 1936, and only 8 issues showed a coverage ratio above 150% at all year-ends.[605]

2. TENDENCY OF THE SPONSOR INTEREST TO DIRECT THE COMPANY INTO HIGHLY SPECULATIVE MANAGEMENT POLICY

The difference in rights and claims awarded the senior and equity securities, respectively, in the multiple-security company subjects the company to pressure in favor of a speculative investment policy. The impetus toward abnormal capital accretion arises from two attributes of the senior-equity structure: (a) The need of such investment companies to maintain a level of earnings and profit greater than the average yield on a diversified list of high-grade investments in order to meet the fixed interest and dividend requirements of the senior securities; and (b) The fact that the bulk of the large profits possibly accruing from a policy of speculation with the total funds of the company will inure to the sponsors while the possibility of loss to the sponsor is limited to its comparatively small investment in the company.[606]

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[602] Ibid.

[603] The limitations of the statistical analyses are given in Pt. Two, Ch. I, pp. 14–18. In connection with the over-all statistics for the coverage of senior securities it should be noted that repurchases, particularly in 1932 and 1933, at prices substantially less than the liquidation values, reduced the principal amount of the senior securities outstanding (Pt. Two, Ch. II, pp. 70–1).

[604] Pt. Two, Ch. II, pp. 77–8.

[605] Pt. Two, Ch. II, pp. 77–8, and Table 11. Table 10 in Ch. II of Pt. Two shows that at the 1930 year-end only 16 of the 21 funded-debt issues had more than 150% coverage, while 2 were "under water"; at the year-end 1932 only 8 out of 22 issues had a 150% coverage, while 6 were "under water"; at the end of 1933, 13 out of 22 issues were "under water."

[606] "One of the basic principles of investment is that the safety of a security with limited return must never rest primarily upon the future *expansion* of profits. If the investor is positive that this expansion will take place, he should obviously buy the common stock and participate in its profits. If, as must usually be the case, he cannot be so certain of future prosperity, then he should not expose his capital to a risk of loss (by buying the preferred stock) without compensating opportunities for enhancement" (Graham, Benj., and Dodd, D. L., *Security Analysis* (1934), p. 163).

a. The Effect of Fixed Senior Charges Upon Investment Policy [607]

An analysis of the percentage rates of earnings required by most of the "leverage" investment companies merely to be in a position to pay the fixed charges on the senior securities and operating expenses shows that these requirements have been considerably in excess of the average rate that might be expected from a diversified list of high-grade investments.

A composite for the 5-year period 1922–26 of the average yields of the stocks in the Standard Statistics indexes of 90 common stocks and 20 high-grade preferred stocks, the rates on 4–6 months' commercial paper, high-grade American railroad bonds, municipal bonds, interest rates on Treasury bonds and rates on call loans, showed 4.72% as the over-all average yield of such a broad diversified policy of investment. Such a composite for the 9-year period 1927–1935 disclosed 4.09% as the over-all average yield.[608] On the other hand, the interest and prior dividend payments and operating expenses required, in the case of many leverage companies, a rate of earnings considerably above the yield that might be expected from devoting the capital of the company to a conservative diversified investment program of the nature suggested above. Thus the Shawmut Bank Investment Trust had to earn at least 5.41% on its contributed capital; National Investors Corporation, 5.45%; General American Investors Co., Inc., 5.40%; Bankers Securities Corporation, 5.55%; Italian Superpower Corporation, 6.43%; Reynolds Investing Company, Inc., 4.95%.[609] The need to meet the charges on the senior securities almost compels an aggressive and venturesome administration of the companies' funds.

Jonathan B. Lovelace, one of the sponsors of The Investment Company of America, testified that the defect in the capital stock of that company was that the company could not be expected to earn a return sufficient to meet the heavy fixed charges on the senior securities.[610]

Q. You thought it had too many senior charges?

A. Yes; when the fund owned $107.00 for each unit and carrying the $7.00 rate, you could not expect to earn a direct return sufficient to carry that.

Edwin Rankin, the specialist on investment for the United Founders Corporation group of investment companies,[611] conceded that because the United Founders Corporation group had outstanding bonds and preferred stocks it had to trade in the market at a time when prudent policy suggested investment in bonds, as the return on bonds would

[607] See supra, pp. 1576–93, which shows that senior capital of investment companies has not earned its keep in net current income. The present section indicates that investment companies with a high leverage would have had difficulty in earning enough, by the use of their entire capital, senior and junior, to service the senior securites, had they followed an average conservative investment policy.

[608] Derived from data given in *Standard Trade and Securities*, published by Standard Statistics Company, Inc., Vol. 3.

[609] Derived from the replies to the Commission's questionnaire for the respective companies. It should be noted that these percentages represent requirements sufficient merely to meet interest and dividend claims of bonds and preference stocks and operating expenses assumed at .45% of capital (Part Two [House Doc. No. 70, 76th Cong.], Ch. II, pp. 78–82) without allowance for any dividend to equity stocks.

[610] Public Examination, American Capital Corporation, at 7328. See Appendix I for capitalization of American Capital Corporation, p. 1939.

[611] Public Examination, American General Corporation, et al., at 24814.

not have been adequate to cover the fixed and priority dividend charges.[612]

Q. Don't you think that prudent investment counselors in the position you people were, with the information you had, might have seen it was the proper time to invest in bonds?

A. I wish we had.

Q. Was there any real consideration given to the possibility of that rather than trading in the market?

A. No. A lot is involved in that whole question. For instance, when an investment company has a bond, or when they have to pay 5% and 6% on the preferred, let us say the over-all is a 5% requirement on its capital, that company can't very well afford to be buying bonds that yield 3% to 4%.

* * * * * * *

Q. But stocks, on the other hand, were yielding very little, the return was little, so all you could hope to do from stocks was to make what you could on appreciation of stocks?

A. I think that is true.

* * * * * * *

Q. You went into trading when you might have taken bonds?

A. The average individual in 1929, a great many, as you know yourself, were completely cleaned out.

The urgent need for a greater than normal yield on portfolio securities or, in lieu thereof, great capital appreciation may be in a large measure responsible for the highly speculative character of the activities of a large proportion of the leverage investment companies, such as the concentration on common stocks in their portfolios,[613] the investment in untried special situations, the inordinate amount of trading and turnover, and the participation in speculative trading accounts.[614]

b. Impetus to a Speculative Policy by the Leverage Set-up [615]

The senior-equity structural set-up creates such a disparity between the possible profits to the sponsor from a speculative policy and the possible losses to the sponsor therefrom as to make the temptation to pursue such a policy almost irresistible to the sponsor. All the surplus profits from the utilization of the entire fund, after deducting fixed obligations to the senior security holders, will accrue to the equity securities, held, in many instances (at least at the inception of the company), by the "insiders." Of the assets thus exposed to loss,

[612] Id., at 24875–6.

[613] The percentages on the combined portfolios (at market value) of the closed-end leverage companies invested in common stocks at the year ends 1929–1936 were as follows (Pt. Two [House Doc. No. 70, 76th Cong.], Ch. VIII, Table 171):

	1929	1930	1931	1932	1933	1934	1935	1936
Closed-end leverage companies	82	76	71	71	78	76	77	80

[614] See Ch. VII in this part of the report dealing with management of assets.

[615] See also supra, pp. 1576–93.

however, the investment of the "insiders" in the company will constitute only a minor proportion.[616] Lansing McVickar, associated with a general brokerage business, who stated that he made a general canvass of investment companies in 1934, very tersely summed up this aspect of leverage:[617]

When there is appreciation, the man who lends the money does not make anything. When there is depreciation, the man who lends the money loses money. Consequently, the leverage reverts entirely to the benefit of the holder of the equity.

The interest of the sponsor, who has much to gain and comparatively little to lose, is naturally in favor of a speculative policy, of taking "long chances," and of engaging in ventures that might conceivably yield great appreciation in the assets. The interest of the senior security holder, on the other hand, is primarily in favor of a conservative policy looking toward a moderate return on capital[618] inasmuch as he is concerned chiefly with the safety of his principal and will realize no benefit even if the hazardous or dangerous enterprises should be successful. Since the determination of policy in the case of the multiple-security company is in the hands of a management which generally represents the leading equity interest, it is natural that such companies should be turned into speculative channels.

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[616] It should be noted that the amount of the sponsor's contribution to the capital of the company is frequently reduced, sometimes entirely retrieved, through commissions on distribution, sale of management options, conversions, repurchases, and other familiar techniques. See infra, pp. 1746–9 and pp. 1874 et seq., and also Ch. II of this part of the report.

[617] Public Examination, First Income Trading Corporation, et al., at 912.

Mr. McVickar testified:

A. * * * As I regard the leverage value, it represents a call on the appreciation over a given point, depending on the amount of money that was borrowed. Leverage, as I would define it, would be the advantage or disadvantage of the use of borrowed money.

Q. Then you agree with my analysis the senior money is like a margin account; is that it?

A. I do; with the qualification that in each of these situations separate contracts have been drawn up, whether bonds, preferred stock, convertible preferred stock, or whatever it may be. Separate contracts have been drawn up when the money was borrowed according to the different ways it was borrowed.

* * * * * * *

Q. Just a minute; you said the leverage factor was a call on the appreciation, but it also was a put on the depreciation, was it not? When it was a loss, it was put to the common stockholders, was it not?

A. When there was a loss, the fellows that put up the money lost the money. When there was a gain, the fellows that borrowed the money made the money.

[618] Yet it should be recalled that the conservative policy desired by the senior security holder is not likely to yield the return on invested capital sufficient to pay the fixed and prior charges and operating expenses of the company (see supra, pp. 1576–94 and 1665–8), and hence the multiple-security company is propelled into a speculative policy for the two reasons mentioned above, namely, the large profits anticipated by the sponsor and the pressure upon the sponsor to meet the fixed charges of the senior securities. A conflict of interest of this nature may exist in any corporation between the senior securities and the equity securities. (See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pt. VII, pp. 109–112, 148–187.) While the conflict in the case of other companies is generally latent and only occasionally demands a decision because the policy and the scope of activity of such companies are usually definite, circumscribed, and well established, the conflict in the case of investment companies is continuous and acute due to the liquidity of their assets and the practical absence of limitation upon the nature of their activities. Since sponsors who control the investment company are often the holders of common stock to a far greater extent than of senior securities, they are in a position to determine such conflicts in the favor of the common stock objective. Thus the conflict of interest in the matter of investment policy may be decided by the management in a nondisinterested fashion. (See supra, pp. 1595–1664, and also infra, pp. 1708 et seq.)

Carroll E. Gray, Jr., out of a long experience with investment companies and familiarity with the state of mind of investors, readily conceded that whereas the senior security holder "does not want to gamble, does not want to subject his money to risks," the individual who holds common stock "is willing to take the longest shot and speculate and get the greatest appreciation if there is going to be an appreciation." [619]

The bulk of the gain redounds to the sponsor's equity when there is a substantial rise in the company's assets, whereas although the losses fall first upon the sponsor's equity interest, the largest aggregate losses fall upon the public's senior investment when there is a serious depreciation in assets beyond the equity cushion.

United States & Foreign Securities Corporation illustrates this condition.[620] The public put up $25,000,000 for the first preferred stock and the sponsors, or the bankers, put up slightly more than $5,000,000 of "junior money." [621] With this set-up, for every dollar of appreciation in the value of the assets of the investment company, 75 cents would be allocable to the sponsors and 25 cents to the public. If the assets depreciated in value, the first $5,000,000 of losses would be suffered by the sponsors. But further depreciation in the value of the assets would be borne by the public—which had $25,000,000 exposed to loss as compared with $5,000,000 hazarded by the sponsors. Actually, the assets of United States & Foreign Securities Corporation increased in value from over $29,000,000 to $52,000,000 by September 30, 1928 (which would mean $25,000,000 applicable to the public and $27,000-000 to the sponsors), and then a new investment company, United States & International Securities Corporation, was formed.

In October 1928, at the height of the prosperity of United States & Foreign Securities Corporation, Dillon, Read & Co., the sponsor, in-

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[619] Public Examination, First Income Trading Corporation, et al., at 871–3. Mr. Gray testified:

> Q. You know, sometimes I wonder what a bond or preferred stock means in the investment trust industry. Usually the justification for the issuance or rationale or raison d'etre for a bond or preferred stock is that the investor is interested primarily in the safety of his principal and he just wants a moderate return, is not that so? That is the underlying philosophy of a senior security. The investor does not want to gamble, does not want to subject his money to any risks. All he wants to be sure of is when the time comes when he can get his money back that he is going to get it. Therefore, he does not want a big cut in the profits, he is satisfied with a moderate return.
>
> A. He wants his principal intact.
>
> Q. His principal intact, that is the thing that is bothering him. He just wants a reasonable return. It is the fellow who has the common stock who is willing to take the longer shot and speculate, and get the greatest appreciation if there is going to be an appreciation; is not that so?
>
> * * * * * * *
>
> A. Yes; correct.
>
> Q. I assume that the salespoint for selling preferred stock or the thing that motivates people in buying preferred and other senior securities, as contra-distinguished from common stock is: "This is my life's earnings. I do not want to shoot crap with this money. I want to make sure my principal comes back to me, and, therefore, I am willing to take a moderate return"; is not that so?
>
> A. Yes; as a result of earning power.

[620] Testimony of Ernest B. Tracy, president, United States & Foreign Securities Corporation and United States & International Securities Corporation. (Public Examination, United States & Foreign Securities Corporation, at 11722–34.)

[621] The sponsor, Dillon, Read & Co., received 75% of the common stock with the issue of second preferred stock; the public received 25% of the common stock with the first preferred stock. See discussion of the financing of United States & Foreign Securities Corporation, supra, pp. 1598–1602.

In the case of many multiple-security structures the senior security holders received no part of the equity securities with the purchase of the senior securities.

vested $10,000,000 of the surplus profits of the United States & Foreign Securities Corporation as "the junior money" in the financing of a new investment company known as United States & International Securities Corporation. The public through the purchase of the senior securities risked $50,000,000 in the new enterprise for which it received the right to only 20% of the potential surplus profits.[622] The Dillon, Read & Co. interests, which held approximately 75% of the equity stock of United States & Foreign Securities Corporation, thus became entitled to approximately 75% of all the surplus profits that might be made by United States & International Securities Corporation without any new investment of money of their own. The character of the risk to its own pecuniary interest assumed by Dillon, Read & Co. is shown by the fact that all the $10,000,000 of surplus profits of United States & Foreign Securities Corporation invested in United States & International Securities Corporation might have been irretrievably lost without impinging upon the $5,100,000 which Dillon, Read & Co. had originally invested in United States & Foreign Securities Corporation.[623]

As a matter of fact, at the end of 1931 the first preferred stock of United States & International Securities Corporation, for which the investing public had subscribed $50,000,000 was $40 per share "under water," representing an unrealized loss to the holders of the first preferred stock (500,000 shares issued) of $20,000,000. Hence the public which held the first preferred stock suffered two-thirds of the $30,000,000 shrinkage in assets,[624] while the United States & Foreign Securities Corporation, which had served in the role of sponsor to United States & International Securities Corporation, suffered only half as great an aggregate loss—to wit, the extinction of asset value in the $10,000,000 second preferred stock issue.[625]

While the above figures for the comparative loss suffered by the senior security holders and United States & Foreign Securities Corporation, the sponsor, illustrate the principle that the senior security holders are exposed to much greater losses than the sponsors, it is vital to observe that the repercussion of the great deflation of the assets of United States & International Securities Corporation upon Dillon, Read & Co. itself was much slighter. The $10,000,000 invested by United States & Foreign Securities Corporation in United States & International Securities Corporation did not constitute the hazarding by Dillon, Read & Co. of its own funds but the exposure of a portion of the surplus profits of United States & Foreign Securities Corporation. In fact, that $10,000,000 represented less than one-fifth of the total assets of United States & Foreign Securities Corporation at that time.[626]

It has been previously shown that at the time of the formation of United States & International Securities Corporation the leverage

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[622] See discussion of the financing of the United States & Foreign Securities Corporation, supra, pp. 1588–1602.

[623] In fact, the Dillon, Read & Co. interests had, by this time, more than retrieved by way of commissions and the sale of a fraction of their common stock the $5,100,000 originally invested. See supra, pp. 1598–1602.

[624] The net assets of the company at this time were $30,000,000 under the original $60,000,000 contributed capital.

[625] Public Examination, United States & Foreign Securities Corporation, at 11745–7.

[626] Id., at 11734.

ratio in United States & Foreign Securities Corporation had declined to approximately 2 to 1, whereas the new company was formed on a leverage basis of 5 to 1.[627] Dillon, Read & Co., by forming the subsidiary, was thus securing for itself the advantages of an increased leverage and at the same time tendering to the prospective senior security holders of United States & International Securities Corporation the disadvantages of that high leverage set-up. There is a definite factual basis for a conclusion that the possibilities of the greater leverage of the United States & International Securities imparted a more speculative character to the activities of that company. The subsidiary invested much more heavily in rails and in a considerable number of "special situations" and had much less cash holdings than the parent, while the latter maintained a much more evenly spread and diversified portfolio.[628] Ernest B. Tracy, president of the two investment companies, conceded that "the two companies had different types of investments."[629] While urging that the substantial interest ($10,000,000) which United States & Foreign Securities Corporation had in United States & International Securities Corporation precluded a management policy "of having the top company have a more conservative position and have the 'kick-out' in the subsidiary," he conceded that this might be a realistic fear in the case of "a company that had a shoe-string interest in a subsidiary."[630]

3. INABILITY OF THE INVESTOR TO DETERMINE THE INTRINSIC VALUE OF THE SECURITIES OF A COMPANY WITH AN INTRICATE CAPITAL STRUCTURE

In even the simplest form of multiple-security set-up, where in addition to the equity stock the company has outstanding either a preference stock or funded debt issue, the individual preference stockholder or debenture holder may experience great difficulty in eliciting information as to his rights or status from the instruments which purport to define such rights, to wit, the charter or articles of incorporation in the case of the preference stockholder and the indenture or agreement between the issuing company and the corporate trustee in the case of the debenture holder.

An examination of 45 funded debt indentures of investment companies disclosed them to be from 40 to 125 pages in length. In the great majority of cases the vital provisions relating to the rights of the debenture holders, as well as the obligations of the company and the trustee, are set forth in involved language. These agreements are scarcely capable of being understood by an individual with the limited knowledge of law and corporate finance with which the ordinary investor is equipped. Similarly a like obscurity in exposition and difficulty of appraisal may be said to prevail with respect to the many rights and qualifications of rights of preference stockholders set forth in the certificates of incorporation. Thus, even in the instance of a "leverage" company issuing but one class of senior securities and one

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[627] Id., at 11734; see supra, pp. 1597–1640.
[628] Public Examination, United States & Foreign Securities Corporation, at 11931–3.
[629] Id., at 11931.
[630] Id., at 11936.

class of equity securities the investor may not easily comprehend his rights or privileges or their significance.

Naturally where a company has issued several varieties of senior securities, the evaluation of the status and rights of the individual security holder becomes correspondingly more difficult and complicated. When the parent company seeks to induce senior security holders of a subsidiary company to convert their holdings into securities of the same company possessing varying rights and characteristics or into the securities of an entirely different company constituting another link in the system, the investor may be confused by the maze of implications or the purport of the alternatives. When a parent and subsidiary hold portions of each other's equity stock, or where investment companies are pyramided and this is frequently accompanied by piling leverage upon leverage and the obscuring of underlying values, an appraisal of the value of his securities may be completely beyond the capacity of the investor. To understand his own position, the investor would have to be a combination of lawyer, accountant, and financial expert. This situation prevails regardless of honest effort on the part of the management to divulge all relevant facts.

a. Eastern Utilities Investing Corporation

Eastern Utilities Investing Corporation affords an illustration of the intricacies that confront the public investor as a result of a complex structure of capital stock and funded debt, with varying and frequently altered rights, privileges, and limitations for each of its securities. In addition, the nature of the portfolio securities held by Eastern Utilities Investing Corporation increased the difficulties involved in an appraisal of the securities issued by Eastern Utilities Investing Corporation. These portfolio securities were mainly issues of debentures or stock of multiple-security companies included in the "System" controlled by Associated Gas and Electric Company interests, and these securities were themselves endowed with varying rights, privileges, and limitations. Moreover, these portfolio companies in turn directly or indirectly held much of the debentures and stock issued by Eastern Utilities Investing Corporation resulting in an intricate maze of crossholdings. Thus, from the time that Associated Gas and Electric Company assumed control, the ascertainment of the intrinsic or potential value of the securities issued by Eastern Utilities Investing Corporation was most complicated and subject to many contingencies and imponderables.

Eastern Utilities Investing Corporation was organized in August 1922 under the sponsorship of H. D. Walbridge & Company, Inc. under the name of Eastern Hydro-Electric Company.[631] In March 1924 its name was changed to Pennsylvania Electric Corporation and it became a holding company for a number of operating utility companies. In September 1925 control of the company was transferred to the Associated Gas and Electric Company interests, which, in a series of transactions, caused the corporation to exchange its operating com-

[631] Public Examination, Eastern Utilities Investing Corporation, Commission's Exhibit No. 3771, Part I, Item 1 (g). See Ch. II of this part of the report for the detailed history of Eastern Utilities Investing Corporation, pp. 624–776 and pp. 790–8.

panies for a portfolio of securities issued by Associated Gas and Electric Company or its affiliated companies; changed the name of the corporation to Eastern Utilities Investing Corporation in July 1927; and purported to change its function to that of an investment company.[632] Although the capital structure of the corporation had previously been relatively uncomplicated with a single issue of common stock and a single issue of preferred stock, the change in the function of the corporation to what was held out to be that of an investment company was accompanied by a reclassifiation of the original issues of securities and a recapitalization by the creation of new issues.[633]

The old common stock with voting power was reclassified on a share-for-share basis into $7 junior preferred stock without voting rights, and the old 7% preferred stock was reclassified into new $7 preferred stock, also on a share-for-share basis.[634] Three additional classes of securities were created: $5.50 prior preference stock, Class A common stock, and Class B common stock.[635]

The $5.50 prior preference stock was entitled to cumulative annual dividends of $5.50 per share before payment of dividends to other securities and a priority in the event of liquidation of $100 per share.[636] The corporation reserved the right to redeem this stock in whole or in part on thirty days' notice at $103 per share. Each share of $5.50 prior preference stock carried two warrants: one entitling the holder to receive without cost one-half of Class A common stock if and when the first dividend was declared on the common stock and the other entitling the holder to purchase one share of $7 preferred stock at $105 before July 1, 1931.[637]

The $7 preferred stock was entitled to cumulative dividends of $7 per share per annum and $100 on liquidation, subject to the priority of the $5.50 prior preference stock and was redeemable at $110 per share.[638] The charter, as amended, empowered the board of directors to adopt a resolution permitting this preferred stock to be converted into $5.50 prior preference stock on a share-for-share basis.[639] Before such priority could be conferred, a certificate was required to be filed with the corporation by its officers affirming that certain specified income requirements had been met.

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[632] For a short period prior to July 1927, the name of the corporation was Eastern Utility Preferred Holding Corporation.

[633] Henry A. Stix, formerly comptroller of Eastern Utilities Investing Corporation and general auditor for Associated Gas and Electric Company, testified (Public Examination, Eastern Utilities Investing Corporation, at 25703):

> Q. You increased the classes of stock, did you not?
> A. Yes; that seemed to be the popular thing those days.

[634] Public Examination, Eastern Utilities Investing Corporation, at 23333–41 and 25699–700.

[635] Ibid. The entire issues of the $5.50 prior preference stock and the Class A common stock were purchased by an Associated Gas and Electric "System" company for the purpose of resale to the public (id., at 25703–4 and Commission's Exhibit No. 3772, Item 6). The transaction took the form of an underwriting arrangement (id., Commission's Exhibit No. 3771, Item 40). The Class B common stock, which constituted the sole voting stock, was also purchased by an Associated Gas and Electric "System" company and was held by a "System" company at all times.

[636] Id., Commission's Exhibit No. 3771, Exhibit A, No. 4.

[637] Id., Exhibit D.

[638] Id., Exhibit A, No. 4.

[639] Id., at 11–13.

The $7 junior preferred stock was entitled to noncumulative dividends of $7 per share per annum and $100 per share on liquidation subject to the rights of the other issues of preferred stock. The redemption price of this issue was $100 per share. According to the charter, as amended, if dividends upon this stock were passed for two years, the holders of this stock obtained the right to select a minority of the board of directors of the corporation. The voting rights of the Class B common stockholders to the extent of the selection of the majority of the board were continued.

The Class A and Class B common stock had equal rights except that the Class A stock had no voting rights.

Easter Utilities Investing Corporation stated in its charter that it reserved the right to issue new or additional classes of securities with "such designations, rights, preferences, privileges, and relative, participating, optional, or other special rights, and with or subject to such qualifications, limitations, and restrictions as the corporation may determine, and which may, in any or every respect, be inferior to, on an equality or parity with, or superior to any class, kind, or series of stock now or hereafter authorized and/or at the time outstanding" solely upon a majority vote of the holders of Class B common stock, except that the corporation denied to itself the right to issue stock with a priority over the $5.50 prior preference stock with respect to dividends, redemption, or liquidating rights unless a majority of that class of stock consented and also denied to itself the right to reduce the rate of dividends, liquidating value, or redemption price of the various issues of preferred stock unless a majority of the affected class of stock consented. In addition, the corporation specifically reserved the right to increase or reduce the amount of shares in each class of security outstanding or to change or alter its preferences, privileges, voting powers, rights, or qualifications, with the above exceptions.

Less than seven months after its issuance, in February 1928, the $5.50 prior preference stock was redesignated $5.50 prior preferred stock by amendment to the corporation's charter.[640] The $7 junior preferred stock was redesignated participating preference stock and, in addition to its existing right to receive $7 noncumulative dividends, was given the right to participate equally in dividends with the Class A and Class B common stock to the extent of $1 per share per annum.[641] The redemption price of the $5.50 prior preferred stock was changed to $105 per share and that of the participating preference stock was changed to $110 per share if that entire outstanding issue were redeemed and $115 per share if only a portion of the issue were redeemed.[642]

In May 1928 the charter was amended with respect to the $5.50 prior preferred stock (formerly $5.50 prior preference stock).[643] The dividend rate was changed to $5 and the redemption price was restored to $103.[644] The new designation was $5 prior preferred stock.

[640] Id., Commission's Exhibit No. 3771, Exhibit A, No. 5, p. 3.

[641] Id., at 5–6.

[642] Id., at 8.

[643] Id., Exhibit A, No. 6.

[644] The securities of this class which had originally been issued in 1927 under authorization of the charter were apparently redeemed in 1928 together with the warrants attached thereto and new securities of this class without warrants, under the amended chapter, were then issued (id., Exhibit A, No. 7, and at 25703).

In July 1928 a new class of preferred stock was issued—$6 preferred stock.[645] This class of security differed from the $7 preferred stock in that its dividend rate was $6 per annum and its redemption price was $105.[646] It possessed all the other attributes of the $7 preferred stock, including the possibility of conversion into the $5 prior preferred stock.[647]

In August 1928 the charter was again amended so as to eliminate the contingent right of the participating preference stock to vote for a minority of the board of directors in the event that dividends were passed for two years on this stock.[648] In the same month the Class A common stock was given the right by charter amendment to receive dividends of 25 cents quarterly before equal dividends were paid to the Class B common stock.[649] Thereafter both classes of common stock were to receive dividends pro rata.[650]

In March 1929 Eastern Utilities Investing Corporation issued 5% gold debentures due March 15, 1954, in the principal amount of $35,000,000.[651] Each 5% debenture in the principal amount of $1,000 carried

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[645] Id., Commission's Exhibit No. 3771, Exhibit A, No. 8, and Item 35.

[646] The charter amendment authorizing this issue also changed the redemption price of the prior preferred stock to $105 per share. Subsequently, on August 8, 1928, the redemption price of $103 per share was restored (id., Commission's Exhibit No. 3771, Exhibit A, No. 8, p. 10, and No. 9, p. 6).

[647] Apparently the $6 preferred stock was created for the purpose of effecting a reduction of the dividend rate and redemption price required to be paid by Eastern Utilities Investing Corporation to holders of its $7 preferred stock, for on August 8, 1928, a letter was addressed to holders of $7 preferred stock offering them the "privilege of exchanging their stock for $6 preferred stock, share for share, plus $5 for each share of $7 preferred stock" (id., Commission's Exhibit No. 3771, Exhibit D). The letter contained the following paragraph, hinting at a redemption of the $7 preferred stock (which never occurred) and threatening a reduced market:

> The holders of a large majority of the $7 preferred have indicated their intention of making this exchange and it is therefore believed that the $6 preferred stock will enjoy a considerably wider market than the $7 preferred stock. Moreover, in the event of the retirement of the $7 preferred stock it is unlikely that a reinvestment could be made on as favorable a basis.

[648] Id., Exhibit A, No. 9. Also changed was the redemption price of the participating preference stock to the sum of $110 per share.

[649] Id., Exhibit A, No. 10, p. 9.

[650] Ibid.

[651] Id., Item 34. The 5% debentures were issued pursuant to the terms of an indenture between Eastern Utilities Investing Corporation and The New York Trust Company, trustee for debenture holders. This indenture, of 76 pages, contained, in technical, legal phraseology, provisions covering the description of the debentures, the amount, execution, registration, and issue of the debentures and covenants of Eastern Utilities Investing Corporation with regard to payment of interest and principal, payment of taxes in certain instances, maintenance of books, records, and its office, execution of further instruments, maintenance of its corporate existence, issuance of additional funded indebtedness, execution of mortgages or pledges, creation of temporary indebtedness, declaration of dividends on junior securities, maintenance of a certain asset coverage for outstanding funded indebtedness, and the filing of a financial certificate with the trustee (id., Commission's Exhibit No. 3771, Exhibit G). Other provisions in the indenture dealt with the redemption of debentures, stock purchase warrants, remedies in the event of default, immunities of officers, directors and stockholders, exculpation of the trustee and other provisions covering the function of the trustee, the effect of consolidation or merger of Eastern Utilities Investing Corporation or a conveyance of all of its assets, and the amendment of the indenture (ibid.). The importance to an investor of carefully appraising these provisions, particularly those which seemingly protected the debenture holder's investment from dissipation or depreciation and those covering the trustees' right to act or to fail to act with respect to these "protective" provisions is clearly demonstrated by the history of the corporation. (See history of Eastern Utilities Investing Corporation, Ch. II of this part of the report, pp. 624–776.) A controversy that occurred in 1932 concerning the amount of debentures "outstanding" may be

with it a warrant entitling the holder to purchase 20 shares of Class A common stock after December 31, 1929, and prior to January 1, 1935, at a price of $15 per share.[652] The debentures were redeemable by the corporation upon payment of a premium of 3%.

Thus by the end of 1929 one series of debentures, three series of preferred stock, one series of participating preferred stock, and two series of common stock [653] of Eastern Utilities Investing Corporation had been issued and were outstanding and each type of security had different rights, privileges, qualifications, and limitations. An investor desiring to appraise the value and status of his stock would not only have to consider the terms of his own security as amended from time to time and the terms of those securities whose specified rights might impinge on his, but would also have to consider the possible exercise of stock-purchase warrants, conversion privileges, and redemption rights. Moreover, the possibility of future alteration in the terms of his security, of the creation of priorities, and of increases and decreases in the amounts of stock issued for each class of security was not remote.[654] This might be accomplished by majority vote of the Class B stockholders (the management) or, in certain cases, by majority vote of the stockholders in his class of security or an 85% vote in the case of the 5% debentures.

The portfolio of Eastern Utilities Investing Corporation mainly comprised securities of various companies of the complex Associated Gas and Electric utility holding company system. The top holding company alone, Associated Gas and Electric Company, had, at the end of 1929, 10 separate debenture issues.[655] Its subsidiary holding companies and operating companies had 30 debenture issues and 15 pre-

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attributed to the phraseology of the indenture. The corporation claimed that only $16,506,000 principal amount of debentures was outstanding because $18,494,000 of debentures was held by a subsidiary of the corporation (op. cit. supra, note 634, at 23821–6, 23836, and Commission's Exhibit No. 3782, Items 49, 58, 59, and 66.) This claim was important with respect to the asset coverage requirements of the indenture. On the other hand, the debentures were not actually retired and the corporation was in a position to allege that all the debentures were outstanding with respect to voting or when computing the percentage of debentures necessary to force action by the trustee on a default by the corporation. (For more detailed discussion of this aspect of the history of Eastern Utilities Investing Corporation, see infra, pp. 1850–8.)

[652] Subsequently, permission was given to holders of warrants to exercise them on or before October 30, 1929, in order that they might secure the right to purchase certain allotment certificates of Associated Gas and Electric Company then being offered to the holders of the Class A common stock (op. cit. supra, note 634, Exhibit D). These allotment certificates were exchangeable for a variety of Associated Gas and Electric Company securities.

[653] In 1928 and 1929 options to purchase some of these issues of preferred and common stock were granted to Associated Gas and Electric Company. These options were exercised in March and August 1929 (id., Item 45). These options while outstanding further complicated the capital structure of the company.

[654] Illustrating the reality of this possibility, it may be noted that on June 21, 1933, an amendment eliminating the "protective provisions" of the indenture covering the 5% debentures was passed. The vote in favor of the amendment was slightly in excess of the required 85% of outstanding debentures (id., at 23884–5). The amendment was passed almost entirely through the voting of debentures held by the Associated Gas and Electric Company and a subsidiary in the principal amount of $13,774,250. Less than $30,000 in principal amount of debentures held by the public voted for the amendment (ibid).

[655] Id., Commission's Exhibit No. 3775 (pp. 32–35). At the end of 1932 Associated Gas and Electric Company had 13 issues of debentures and 10 issues of preferred stock (*Moody's Manual of Investments, Public Utilities,* 1933, pp. 1523, 1529).

ferred stock issues then outstanding.[656] Bonds and preferred stocks were issued by affiliated companies of the "System" not included in the consolidated financial reports. These security issues presented the same type of complexities and were subject to the same contingencies and uncertainties as the securities issued by Eastern Utilities Investing Corporation.[657] The necessity of evaluating such assets of Eastern Utilities Investing Corporation added to the difficulties confronting the investor in seeking to ascertain the real worth of his stock or coverage for his debentures.

Besides the difficulties and contingencies attending an appraisal of the securities of the "System" companies, a further complication resulted from cross-holdings. Eastern Utilities Investing Corporation held, in its portfolio, securities issued by companies in the Associated Gas & Electric "System," which, in turn, held securities issued by Eastern Utilities Investing Corporation. Chart 7 portrays this situation on December 31, 1929. This circular ownership, in itself a matter of considerable complexity, was rendered more intricate by the fact that many of these portfolio companies did not directly possess Eastern Utilities Investing Corporation securities, but held securities or obligations of companies that held Eastern Utilities Investing Corporation securities.

The interrelationship among the "System" companies was by no means static and the amount and identity of "System" securities in the portfolio of Eastern Utilities Investing Corporation were also constantly changing in major respects. For example, Eastern Utilities Investing Corporation, immediately after the issuance of its debentures, had an investment of $7,349,920 in Associated Gas and Electric Company $5 preferred stock.[658] Additional blocks of this $5 preferred stock were acquired from time to time until October 1929, when the corporation sold 130,000 shares of this $5 preferred stock for $11,700,000, the approximate market price, and purchased in lieu thereof $12,300,000 principal amount of Associated Gas and Electric Company 6% debentures for $11,685,000.[659] A portion of these 6% debentures, $9,916,300 principal amount at par, were sold in May 1930. During that month Eastern Utilities Investing Corporation paid to Associated Utilities Investing Corporation $9,916,300 for 99,163 shares of second preferred stock of Gas and Electric Associates, an affiliate of Associated Gas and Electric Company. In September 1930 Eastern Utilities Investing Corporation sold back 63,163 shares of that second preferred stock to Associated Utilities Investing Corporation and repurchased 6% debentures, a transaction involving $6,317,500.[660]

These transactions illustrate the size and rapidity of shifts in and out of the securities of the "System" which Eastern Utilities Investing

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[656] Public Examination, Eastern Utilities Investing Corporation, Commission's Exhibit No. 3775, pp. 32–5.

[657] In his *Financial Policy of Corporations*, Arthur S. Dewing, after setting forth a copy of the balance sheet of Associated Gas and Electric Company for December 31, 1932, states (p. 21):

> In spite of the array of figures and valuations, it is absolutely impossible to form any idea of what the final or residual common stock, called here Class B common stock, represents in terms either of property or earnings.

[658] Op. cit. supra, note 656, Commission's Exhibit No. 3772, Item 4 and No. 3805.

[659] Id., Commission's Exhibit No. 3771, Part VII, Tables 32 and 33.

[660] Ibid.

Corporation was required to make in transactions with "System" companies. Obviously it would be a practical impossibility for an ordinary investor to evaluate his security on the basis of these transactions, even if he were apprised of them, having in mind the intricacies of the securities of Eastern Utilities Investing Corporation, the securities of the portfolio companies, and the intercompany holdings, as well as the contingencies to which all these securities and holdings were subject.

A security holder was frequently called upon to decide upon the merits of exchange offers, an almost hopeless task in the light of all the factors involved. The Associated Gas and Electric Company interests, practically from the time of acquisition of control of Eastern Utilities Investing Corporation, solicited the exchange of the capital stock securities of Eastern Utilities Investing Corporation held by the public. Approximately two years after the issue of the 5% debentures the Associated Gas and Electric Company interests embarked upon an exchange program with respect to these debentures also. The holders of every class of securities from Class A common stock to 5% debentures were repeatedly deluged by offers to exchange their securities for various securities of Eastern Utilities Investing Corporation or Associated Gas and Electric Company or its subsidiaries or affiliates. Thirty-nine different offers of exchange to the various security holders of Eastern Utility Investing Corporation have been noted in the period from December 1927 to August 1934.[661]

A single instance of the difficulties involved in these exchange offers may be cited. In November 1928 the $7 preferred stock of Eastern Utilities Investing Corporation was given the right, within a limited time, to convert that stock into 5½% convertible investment certificates issued by Associated Gas and Electric Company on the basis of $111.11 principal amount of certificates for each share of preferred stock.[662] While this conversion privilege was the result of a charter amendment, in effect it was no more than an exchange offer and was treated as such. The 5½% convertible investment certificates of Associated Gas and Electric Company themselves had three conversion privileges. The holder was entitled to convert each $1,000 certificate in the following ways:[663]

(a) At holder's option into a like principal amount of 5% Convertible Gold Debentures due 1965 of Associated Gas and Electric Company which were convertible at holder's option on and after November 15, 1933, to November 15, 1943, into ten shares of its $5.50 Series Preferred Stock for each $1,000 debenture; or

(b) At holder's option at any time into 15 shares of stock of Eastern Utilities Investing Corporation, consisting of three shares of $5 Prior Preferred Stock, two shares of $6 Preferred Stock, five shares of Participating Preference Stock, and five shares of Class A Common Stock; or

(c) After November 15, 1933, at option of either Associated Gas and Electric Company or the holder into ten shares of $5.50 Series Preferred Stock of Associated Gas and Electric Company.

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[661] Id., Commission's Exhibits No. 3771 (Exhibit D) and No. 3772 (Sec. 38).

[662] Id., Commission's Exhibit No. 3771, Exhibit A, No. 11.

[663] *Moody's Manual of Investments, Public Utilities,* 1929, p. 559.

CHART 7

RELATIONSHIP OF EASTERN UTILITIES INVESTING CORPORATION TO THE ASSOCIATED GAS AND ELECTRIC COMPANY SYSTEM DECEMBER 31, 1929 [a]

Securities issued by Eastern Utilities Investing Corporation that were held by Associated Gas and Electric System companies

Shares — *Class*

Securities issued by Associated Gas and Electric System companies that were held by Eastern Utilities Investing Corporation

Shares or par — *Class*

ASSOCIATED GAS AND ELECTRIC PROPERTIES

GAS & ELECTRIC ASSOCIATES → 80,000 $8 Preferred

MANSON SECURITIES TRUST

→ 50,150 Participating Preference, held by → NEW ENGLAND GAS AND ELECTRIC ASSOCIATION

ASSOCIATED SECURITIES CORPORATION

ASSOCIATED GAS AND ELECTRIC COMPANY → $249,754.71 Class A; $10,150,000 6% Conv. Deb. →

→ 69,676 $5 Prior Preferred, 60,500 $6 Preferred, 166 $7 Preferred, 64,773 Participating Preference, 712,226 Class A Common, held by → ASSOCIATED UTILITIES INVESTING CORP. (Del.)

MANAGEMENT HOLDING CORPORATION → 50,000 7% Preferred →

J. G. WHITE MANAGEMENT CORP. → 1,000 7% Preferred →

ASSOCIATED GENERAL ELECTRIC CORP.

→ 50,000 Participating Preference, held by → GENERAL GAS & ELECTRIC CORP. → 99,775 Class A; 198,430 Class B →

BARSTOW SECURITIES CORP.

W. S. BARSTOW & CO., INC. → 50,000 7% Preferred →

Held by

→ 500,000 Class B Common, held by → EASTERN UTILITIES INVESTING TRUST

← CAPITALIZATION OF EASTERN UTILITIES INVESTING CORPORATION ←

Security	*Held in system*	*Held by public*	*Total*
$5 Prior Preferred	69,676	5,324	75,000
$6 Preferred	60,500	4,202	64,702
$7 Preferred	166	10,132	10,298
Participating Preference	164,923	8,999	173,922
Class A Common	712,226	197,818	910,044
Class B Common	500,000	----------	500,000
5% Debentures Due 1954		$35,000,000	$35,000,000

[a] Derived from reply to the Commission's questionnaire for Eastern Utilities Investing Corporation. Subsidiaries are shown by indentation under parent companies.

The $7 preferred stock was thus convertible pursuant to the amended terms of the charter into the $5 prior preferred stock of Eastern Utilities Investing Corporation or into 5½% convertible investment certificates of Associated Gas and Electric Company, which in turn were convertible in three different ways, including the conversion into debentures which were again convertible into preferred stock. The $7 preferred stock was also convertible into the $6 preferred stock pursuant to an exchange offer.

Similar situations confronted the holders of all the classes of securities of Eastern Utilities Investing Corporation at frequent intervals. Obviously, an investor interested in ascertaining the intrinsic and prospective values of the various securities offered compared with his own was presented with a task that must be considered impossible as a practical matter. It is doubtful whether an investor could reach even an approximation of these values.

b. Central States Electric Corporation

Central States Electric Corporation (at times referred to as Central States) illustrates, particularly at its peak size in September 1929, the multitudinous and almost incomprehensible complications that may develop in an investment company because of the pyramiding of one company upon another and the variety of securities in the capital structure of each company. For those security holders who desired to understand their legal rights and to follow the investment merits of their securities and of the assets supporting such securities, the set-up of Central States presented almost insurmountable difficulties. Not only was there a multiplicity of securities in the Central States capital structure, but the individual securities possessed a variety of reciprocal privileges and priorities, and in turn were subject to a number of other privileges and priorities. Finally the actual operations and activities [664] of Central States and of affiliated persons and companies increased the already existing obscurities and accentuated the lack of relation between underlying values and market prices generally prevalent in 1929 prior to the stock market crash.

(1) INTERLOCKING SECURITY RELATIONSHIPS AS OF SEPTEMBER 1929

The complicated interlocking security relationships are illustrated by the situation in September 1929, when Central States itself had six classes of security issues outstanding which were senior to its outstanding common stock. In addition, Central States, directly or indirectly, held blocks of stock sufficient to give it control of or influence in four other investment companies, as shown for the end of 1929 by Chart 8. Each of these investment companies had issues of junior and senior securities outstanding.[665]

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[664] A number of the transactions and activities, hereinafter noted as increasing the complexity, are independently of great importance. However, the other aspects of these transactions are not analyzed in detail here.

[665] Public Examination, Central States Electric Corporation, Respondent's Exhibit No. A; see also id., Commission's Exhibit No. 1207. For a brief discussion of the formation of Central States Electric Corporation in 1912 and the formation of the other four investment companies in the group between November 1928 and August 1929, namely, American Cities Power & Light Corporation, Electric Shareholdings Corporation, Shenandoah Corporation, and Blue Ridge Corporation, see Pt. One (House Doc. No. 707, 75th Cong.), p. 70.

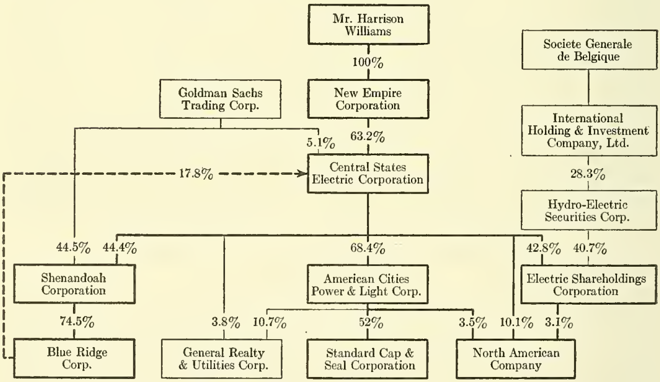
With the issue of $25,000,000 principal amount of 5½% debentures in September 1929 (its last security issue), Central States had outstanding two classes of debentures, an issue of first preferred stock, three different classes of second preferred stock, and an issue of common stock, as follows:[666]

Debentures:	
Opt. 5½% conv. debentures (issued September 1929, due 1954)	$25,000,000
5% conv. debentures (issued January 1928, due 1948)	19,326,000
Preferred stock:	
7% (first) preferred stock, $100 par (issued 1912, 1913, and 1925)	7,543,300
Serial (second) preferred stock, $100 par:	
6% series (issued April 1928)	10,340,000
Opt. dividend series—Conv. of 1928 (issued September 1928)	4,215,400
Opt. series of 1929 conv. (issued June 1929)	6,808,900
Common stock (without par value, 10–1 split-up in 1926)	8,280,850 shares

CHART 8

CENTRAL STATES ELECTRIC GROUP

DECEMBER 31, 1929



NOTE: Affiliated companies holding less than 3% not indicated.

SOURCE: Public Examination, Central States Electric Corporation, Commission's Exhibit No. 1207.

The purchaser of the new debentures issued in September 1929, like the purchasers of most of the other security issues of Central States, in order to understand the rights and interest conferred upon him by his security had to be able to analyze a perplexing array of prefer-

[666] Public Examination, Central States Electric Corporation, Commission's Exhibit No. 1237.

ences, limitations, terms, and conditions of a complicated legal nature [667] which attached not only to these debentures but also to the other outstanding securities of the company. These debentures carried warrants to buy Central States common stock and also coupons enabling the holder to receive common stock in lieu of interest in cash. As a consequence the debenture holder was directly interested in the merits and experience of the common stock of the company and in the rights and privileges of all securities senior to that common stock.

Of a somewhat different pattern, the earlier debentures sold in January 1928 were convertible into preferred stock of the 6% series but were not granted the warrants to purchase The North American Company common stock that attached to the other 6% preferred stock of the same series when it was offered in April 1928. The next issue of preferred stock, of September 1928, on the other hand, was convertible into Central States common stock, as was the preferred stock issue of June 1929, except that the privileges on conversion were cut in half in the latter case. Furthermore, the board of directors had broad powers to alter radically the capital structure by selling additional issues, since in September 1929 less than one-seventh of the authorized second preferred stock and only two-fifths of the authorized 5% debentures had been issued, while the 5½% debentures first sold in September 1929 could be issued without limit.[668] The investor, in order to evaluate the common stock inducements attached to the debentures of 1929, was thus faced with a constantly shifting capital structure and a continuous threat of dilution [669] and changes in his interest due to these conversion rights and to the special, optional, and periodic dividends paid by the company. In fact, the value of every class of security was complicated by the variety of rights and privileges possessed by it and the other classes of securities and by a number of constantly changing factors in the operation of the Central States group of companies over which the investor had no control and of which he had little or no knowledge.

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[667] The rights of the debenture holder are set forth in an indenture of 59 printed pages of technical legal provisions and in a supplemental indenture of 46 pages (reply to the Commission's questionnaire for Central States Electric Corporation, Pt. I). The earlier 5% convertible debentures due in 1948 were issued pursuant to the terms of a 55-page indenture and a 65-page supplemental indenture (ibid.). The certificate of incorporation defining many of the rights of security holders contained 50 printed pages (op. cit. supra, note 666, Commission's Exhibit No. 1204).

[668] Op. cit. supra, note 666, Commission's Exhibit No. 1237.

[669] A recognition of the dilution possibilities is found in the complicated so-called protective provisions for the convertible preferred stocks set up in the company's certificate of incorporation, as amended. These provisions were "designed to protect the conversion privileges of, and stock dividends on, preferred stock * * * against dilution in the event of the issue or sale, pro rata to holders of the company's common stock, of additional common stock (other than stock issued by way of dividends upon the common stock at a rate not exceeding 2½% per quarter) and in the event of a capital reorganization, consolidation, merger, or sale" (id., Commission's Exhibits Nos. 1204 [certificate of incorporation] and 1228). None of the outstanding classes of preferred stock had voting rights, except the 7% preferred stock of 1912, and one issue had the right to participate ratably in new issues of common stock (id., Commission's Exhibit No. 1204).

(2) RELATION OF COMPLEXITIES TO ORGANIZATION AND EARLY GROWTH OF COMPANY

These complications were in many instances the direct outgrowth of a capital structure apparently created to serve the interests of and to facilitate the activities engaged in by the organizer of the company and its controlling figure throughout its history—Harrison Williams. Mr. Williams had the company at its organization adopt a multiple-security structure consisting of debentures, preferred stock, and common stock,[670] in order to carry out his purposes of control and methods of financing.

On May 28, 1912, Mr. Williams caused Central States Electric Corporation to be incorporated for the express purpose, as stated in its charter, of financing the purchase and holding of not less than 60% of the common stock of The Cleveland Electric Illuminating Company,[671] the principal operating utility company in the city of Cleveland, Ohio.[672] The method pursued by Mr. Williams in the formation of Central States was admitted by him to have been at the time the "conventional method of getting the public to buy and another person to control."[673] Financed mainly by a loan from a bank, Mr. Williams secured a large block of shares (60% of the total outstanding) of the common stock of The Cleveland Electric Illuminating Company for $5,724,000 ($130 per share).[674] These shares he turned over to Central States at that price and caused the company, in return, to issue to him almost twice this amount in face amount of its securities, an aggregate of $10,568,000, consisting of 5% "Gold Notes," preferred stock, and common stock.[675] Part of these securities of

[670] Op. cit. supra, note 666, at 12260–3, 12273, and 12277–8.

[671] See Certificate of Incorporation under the laws of the State of Virginia of Central States Electric Corporation (id., Commission's Exhibit No. 1204).

[672] This was an operating utility with gross earnings in 1912 of over $3,000,000 (*Moody's Manual of Investments, Public Utility Securities,* 1913, p. 1519).

[673] Op. cit. supra, note 666, at 12268. In this respect Mr. Williams testified (id., at 12278–9):

> Q. Now, Mr. Williams, can you please tell us what was the economic function or the economic justification that you saw at that time for superimposing on this independent, well-run utility company, a holding company like Central States?
> A. It wouldn't be possible for me to go back. I don't know what my ideas were at the time. I don't think there were any ideas other than buying the company.
> Q. Other than buying it, so that you would have a medium whereby securities could be sold to the public, isn't that so?
> A. Right.
> Q. And the public would finance your ownership of the Cleveland Illuminating Company?
> A. Right; would finance the ownership. They would become the owners.
> Q. But you would become the owner because you held the common stock?
> A. I would have an amount of the common stock or other securities which, in part, I paid for.
> Q. But your common stock was a bonus. We just agreed on that.
> A. Well, of that I am not sure whether it was all bonus or not. It was some of it that was bonus.

[674] Id., at 12260–5.

[675] This basket of securities was made up as follows (op. cit. supra, note 666, at 12258–72):

5% secured Gold Notes due June 1, 1922	$3, 730, 000
31,080 shares of $100 preferred stock	3, 108, 000
37,300 shares of $100 common stock	3, 730, 000
	10, 568, 000

The charter provided that for each share of $100 (par value) of The Cleveland Electric Illuminating Company stock there should be issued approximately 64/100 of a share of common stock, 77/100 of a share of preferred stock and $77 of gold notes. (See id., Commission's Exhibit No. 1204.)

Central States were then sold by Mr. Williams to the public through small investment bankers during a period of several months thereafter. By this means he paid off his loan at the bank, reimbursed himself for his original investment in The Cleveland Electric Illuminating Company,[676] and retained a block of common stock as a bonus. In this respect Mr. Williams testified:[677]

Q. That is, the public bails you out of the loan to the Guaranty Trust.
A. Right. My recollection is that I received the amount that I had paid for the stock [of Cleveland Electric Illuminating Company]—no profit on the stock—but that I did receive a bonus.
Q. Of common stock?
A. Of common stock.

By the end of 1913 Mr. Williams, through this method of financing and aided by a multiple type of capital structure, had been able, at a cost of not over $72,000, to secure 32% of the common stock of Central States, of which a substantial portion had been received as a bonus.[678] This common stock, in turn, gave Mr. Williams control or a dominant influence over Central States Electric Corporation[679] and thereby over The Cleveland Electric Illuminating Company from 1912 to 1922.[680]

One of the early complications traceable to its original security structure was created in 1922 when Central States, in order to pay off the principal obligations on its debentures due in that year, was compelled to sell its majority block of stock of The Cleveland Electric Illuminating Company.[681] With these debentures paid off the capital structure of Central States consisted of over $4,500,000 par value of preferred stock and 54,519 shares of ($100 par) common stock. However, the sole asset of Central States was approximately $3,400,000,

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[676] Ibid. Any excess received by Mr. Williams from the sale of Central States' securities over the amount that he was paid for the Cleveland Electric Illuminating Company stock was turned over to Central States (id., at 12276).

[677] Op. cit. supra, note 666, at 12268.

[678] Id., at 12314, 12321, 12282–4, and Commission's Exhibit No. 1205. In addition Mr. Williams invested approximately $2,000,000 in Central States common stock in 1922, 1923, and 1924, or a total investment of $2,072,000 (id., at 12321). In two years, 1927 and 1928, cash dividend payments to Mr. Williams on his common stock had approximately equaled his total investment in the company (id., at 12630).

[679] Mr. Williams became Chairman of the Board of Directors of The Cleveland Electric Illuminating Corporation in 1914 and its president in 1916 (id., at 12256–7 and Report of the Federal Trade Commission upon Utility Corporations (Sen. Doc. 92, 70th Cong.) Pt. 33 at 665, et seq.).

[680] Although the public primarily financed the acquisition of control of The Cleveland Electric Illuminating Company through purchasing primarily the senior securities of Central States, no part of the original money raised went into The Cleveland Electric Illuminating Company. Mr. Williams testified (op. cit. supra, note 666, at 12274–5):

Q. Did one nickel of the $9,000,000 [sic; $10,500,000 face amount] worth of stock and notes, which was initially sold by the Central States Company, go into the Cleveland Illuminating Company?
A. No.
Q. No. So that when Central States was organized, as far as Cleveland Illuminating Company was concerned as an operating unit, it didn't add anything to Cleveland, isn't that so?
A. No, right.

* * * * * * *

Q. So, we had Central States Company, which was organized by you and your associates, deliberately superimposed on Cleveland Illuminating Company, which was an operating company, going along and minding its own business up to that time. Isn't that so, Mr. Williams?
A. Right.

[681] Op. cit. supra, note 666, at 12289–93.

entirely in cash.[682] Central States was not liquidated at this time, but rather, in a transaction which was admitted to be somewhat similar to a margin account,[683] Mr. Williams caused the company to borrow \$1,920,000 from banks and invest this entire borrowing and its total cash assets (an aggregate of approximately \$5,320,000) in the common stock of The North American Company, a public utility holding company[684] in which he had earlier secured an interest.[685] Thus, although the express purpose stated in its charter,[686] and on the basis of which its securities were originally sold, was for Central States to be a majority holder of an operating utility company (The Cleveland Electric Illuminating Company) the nature of Central States was completely changed to that of a holding company of a large minority block of common stock of The North American Company, which was itself a holding company.

(3) FACTORS IN SUBSEQUENT GROWTH CREATING COMPLEXITIES

After 1922, the investor in Central States found himself faced with an increasing number of complexities, which individually and cumulatively tended to render difficult, if not impossible, an accurate understanding of the rights and values of his securities. While substantial problems for the investor were introduced before 1928 by the constant financing and refinancing of Central States and by Mr. Williams' trading in The North American Company common stock, major difficulties were created by the tremendous expansion in financing and in trading activities in 1928 and 1929. This expanded financing and trading activity combined with other factors, such as interrelated preferred stock conversion features, pyramiding, circular ownership and cross-holdings of investment companies in the group and the treatment of stock dividends, and helped to produce the wide variance between asset and market values which existed in September 1929.

(a) Financing of Central States Electric Corporation and Companies in the Group

The security complications of Central States steadily increased from 1922 to 1929 as it engaged in successive public and private financing and refinancing on an ascending scale in order primarily to purchase more common stock of The North American Company. The principal objectives of Central States during this period were apparently made to coincide with the principal objectives of Mr. Williams, its sponsor—raising additional public funds to purchase additional common stock of The North American Company[687] and to conduct the

[682] Thus its common stock would have been worthless if this company had been liquidated, as the preferred stock was "under water" (id., at 12302–3 and Commission's Exhibit No. 1205).

[683] Id., at 12304.

[684] This block consisted of 59,000 shares, roughly 14% of the outstanding stock of The North American Company (id., at 12504–6 and Commission's Exhibit No. 1213).

[685] Id., at 12293 et seq.

[686] Id., Commission's Exhibit No. 1204.

[687] This financing permitted the acquisition of more and more of the common stock of The North American Company as the sole or principal asset of Central States and resulted in an increase in the common stock control of North American from 14% by Central States in 1922, to 28% by Central States and its affiliated companies in 1929 (id., at 12304–6, 12380–404 and Commission's Exhibit No. 1213).

affairs of Central States so as to increase the value of its common stock, which was almost entirely held by Mr. Williams.[688] The large number of various issues with their special features may be traced in substantial measure to an effort to attract public funds by distributing securities with sales appeal. The public was induced to purchase, almost entirely, senior securities[689] with limited and fixed claims to income and principal, except that attached to each security issue, in order to make the security more attractive for sale,[690] were various features such as warrants to purchase North American stock, conversion rights into Central States common stock, options to take dividends in stock, and options to take interest payments in stock. Only a few of the securities sold prior to 1928 and 1929 (and not one of those sold in 1928 and 1929) by the Central States group of companies failed to have these special features.[691]

Thus, in 1923, Central States in connection with its sale of $4,000,000 in gold notes, offered a number of inducements: the notes bore an interest rate of 7%; matured in only two years; were secured by 400,000 shares of North American common stock; and finally, each note had the right to buy 20 shares of North American common stock from Central States at varying prices ranging from $23 to $29 a share.[692] By November of 1925 the company had been able to sell $10,000,000 in gold debentures with lesser sales inducements. These debentures were of 20-year maturity instead of two years; paid 6% instead of 7%; and, although a much larger issue than the previous one, were secured by only 300,000 shares of North American common stock. Warrants were also attached to each debenture on the basis of 10 shares instead of 20 shares of North American common stock and were exercisable at much higher prices, ranging from $85 to $125 a share.[693] A

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[688] The percentages of Mr. Williams' holdings of the common stock of Central States of the total outstanding shares at various year-ends from 1912 to November 1929 were as follows (op. cit. supra, note 666, Commission's Exhibit No. 1205):

	Percent		*Percent*
1912	27.5	1924	96.0
1913	32.3	1927	96.0
1922	63.9	1928	97.1
1923	79.2	1929	81.5

[689] Op. cit. supra, note 666, at 12386–9.

[690] Id., at 12654–7, 12704–7, and Commission's Exhibits Nos. 1224, 1228, 1235, and 1237.

[691] James Forrestal, of Dillon, Read & Co., bankers for various issues of Central States, admitted that there was a gradual step-up of appeal to the investor in 1928 and 1929. In this respect Mr. Forrestal testified (id., at 12654–5):

Q. You might not like the term, but it is dressing up.
A. I don't think so. You put in the features——
Q. That you think will sell the security.
A. I think it is both. I believe that a man that buys any fixed income security, if he has a chance to participate in the equity—that will appeal to him.
Q. It is extraordinary that there is a constant increase in the dressing up of these securities.
A. I think there was in the whole market.
Q. I mean in these securities in 1928 and 1929.
A. It was not singular to these securities.
Q. I am not saying that, but there was an increasing dressing up of these securities.
A. I don't think it was increasing. There were varying features on these different issues. But I don't think it increased it. There is a gradual stepping up of appeal to the investor.

See also in this respect Ch. III of this part of the report, pp. 904–11.

[692] Op. cit. supra, note 666, at 12381, 12324–6, and *Moody's Manual of Investments, Public Utility Securities*, 1924, p. 63.

[693] Op. cit. supra, note 666, at 12386–7, *Moody's Manual of Investments, Public Utility Securities*, 1926, p. 31, and derived from supplementary information supplied the Commission for Central States Electric Corporation.

third and later issue further illustrates the dependence on warrants to purchase North American common stock, and the trend toward smaller inducements to the investor to purchase these senior securities. On April 12, 1928, Central States was able to sell $10,000,000 of 6% preferred stock, instead of 6% debentures. This preferred stock likewise had warrants to buy North American common stock from Central States on a share-for-share basis but at prices ranging from $72 to $82 a share of North American common stock, depending upon whether the purchaser was among the first, second, or last third of the group to exercise the warrants.[694] Thus, the investor in each of these issues was required not only to evaluate the Central States security but also the North American Company common stock and the effect of the exercise of these warrants on the assets of Central States.

(b) Trading in The North American Company Common Stock

Further complexity was introduced by the personal trading and distribution activities of Mr. Williams and those of Central States in North American common stock, in which the majority of Central States' assets, based on market prices, was invested from 1922 through 1935.[695] These operations were conducted from May 1924 to September 30, 1929, during which time the market prices of the common stock of The North American Company rose over 600%,[696] while the Standard Statistics Company index of 40 utility securities rose only 340%.[697] Moreover, from 1924 to 1929, the earnings per share of North American common stock rose only 53%.[698] Yet Mr. Williams, through his wholly-owned company, North American Securities Company (hereinafter referred to as Nasco),[699] engaged in purchasing from May 1924 to October 1928 some $121,000,000 of this North American common stock on the New York Stock Exchange and in distributing over 90% of this stock so purchased off the exchange[700] to small investors throughout the country in a manner designed to lessen the likelihood of its return upon the exchange.[701] During this period the market price of the common stock of The North American Company was subjected to a strong market influence because of the substantial nature of market purchases and of this policy of buying on and selling off the stock market.[702] All of the new securities of Central States after

[694] Op. cit. supra, note 666, at 12671–82 and Commission's Exhibit No. 1224. A further complication to the security structure arose from the fact that the debentures issued some 3 months before were convertible into preferred stock of equal rank which did not possess warrants (id., at 12655–7).

[695] Id., at 12380 et seq., and Respondent's Exhibit No. A and the reply to the Commission's questionnaire for Central States Electric Corporation, Pt. III.

[696] Based on closing bid prices for last day of each month in the *Bank and Quotation Record*. See also op. cit. supra, note 666, Commission's Exhibit No. 1208.

[697] *Standard Trade and Securities*, Vol. 3, published by Standard Statistics Company, Inc.

[698] Op. cit. supra, note 666, Commission's Exhibit No. 1213.

[699] Id., at 12365, 12367, and 12371.

[700] Id., Commission's Exhibit No. 1214.

[701] Id., at 12571 and Commission's Exhibit No. 1215.

[702] For example, purchases by Nasco amounted to approximately 20% of the total stock exchange purchases for the years 1924 through 1927 (id., at 12579 and Commission's Exhibits Nos. 1212 and 1214) and there were no substantial counterbalancing sales on the exchange except those that resulted from the stock dividends of The North American Com-

1922 were sold primarily on the performance of The North American Company and its common stock.

Furthermore, these market and distribution activities by Mr. Williams, which continued until October 1928, coincided with substantial purchases of North American Company common stock by Central States and the other companies in the group.[703] The Central States group of companies steadily increased its holdings until 26% of the outstanding North American common stock was held in 1929.[704] While a substantial portion of the circulars offering securities of Central States during this period was often devoted to the earnings and assets of The North American Company, no mention whatsoever was made of Mr. Williams' market and distribution activities in North American company common stock.[705] Even if these activities had been disclosed and securities of Central States had still been purchased with a knowledge of their existence, the investment merits of these securities would be subject to constant variations and influences which would defy accurate appraisal.

(c) Expansion of Financing and Trading Activities in 1928 and 1929

While from 1924 to 1928 the principal trading activity which accompanied the securities distribution of Central States was in the common stock of The North American Company, it was in the major period of securities distribution by the Central States group from January 1, 1928 to September 1929 that a multiplicity of trading and security distribution activities existed to impede a true appraisal of the Central States security relationships. From 1922 to the end of 1927 Central States had raised by successive financing and refinancing approximately $13,700,000 net additional new money from the public by three different issues of Gold Notes, an issue of gold debentures, and an issue of preferred stock, and had borrowed as well approximately $5,000,000 from other sources.[706] Yet in a year and three-quarters, from January 1928 through September 1929, Central States alone and with others brought about the sale of approximately one-half billion

pany coming back on the market. However, the amount of stock exchange market purchases over the period was more than double the total stock dividends over the period May 1924 to December 31, 1927 (id., at 12564–74) while Mr. Williams estimated that not more than 34% or 40% (id., at 12533) of these stock dividends would probably flow back on the stock exchange. During this same period Mr. Williams was, in addition to the distribution operation referred to above, purchasing the common stock of The North American Company on his own behalf. (Derived from supplementary information supplied the Commission for Central States Electric Corporation.)

[703] Derived from supplementary information supplied the Commission for Central States Electric Corporation (summary of The North American Company common stock purchases), and op. cit. supra, note 666, Commission's Exhibit No. 1330. In 1929 Nasco apparently ceased distributing the common stock of The North American Company and concentrated on the purchase on the stock market and retail distribution off the stock market of the common stock of Central States and the securities of other companies in the group (op. cit. supra, note 666, at 12575–8).

[704] Op. cit. supra, note 666, Respondent's Exhibit No. A.

[705] Thus one out of the four pages of the circular of the issue of preferred stock of 1928 was devoted to a description of The North American Company, the nature of its business and its earnings (id., Commission's Exhibit No. 1224).

[706] Op. cit. supra, note 666, at 12380–403 and 12624–39.

dollars of security issues of its own and of affiliated companies.[707] Approximately half of these securities were sold directly to the public and the other half were sold to companies affiliated with Central States.[708] The distribution of securities in these two years involved, among other things, the successive formation of four new investment companies in 1928 and 1929 with only a few months intervening between each new organization.[709] With roughly 80% of the common stock of each new company held or controlled either directly or indirectly by Central States alone or jointly with another investment company, a pyramided and complex investment company system was created.[710] Each new investment company, except Shenandoah Corporation, took over substantial blocks of the North American common stock at or near formation, thus aiding the market and distribution activities of Nasco in this stock and permitting the indirect sale to the public of large blocks of the North American common stock at the

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[707] The consolidated financing by Harrison Williams—Central States Group, 1928–29—is illustrated by the following schedule (dollars in thousands):

Date	Name of issuer	Description	Total issued [a]		Original amounts acquired by	
			Shares or principal amount of debentures	Total realized	General public	Affiliated or sponsor companies
1928						
Jan. 1	Central States	Deb. 5–1948	$18,600	$18,600	$18,600	None
Apr. 12	Central States	6% pfd	100,000	9,650	9,650	None
Sept. 5	Central States	Opt. div	100,000	9,378	9,378	None
Oct. 1	American Cities	Com. B	1,600,000	16,165	None	$16,165
Oct. 4	Central States	Opt. div	10,000	935	935	None
Nov. 14	American Cities	Units {pfd. [a] com. B	400,000 400,000	23,900	23,900	None
Total, 1928				78,628	62,463	16,165
1929						
Feb. 6	American Cities	Units {pfd. A com. B	25,000 25,000	1,538	1,538	None
Mar. 20	Electric Shareh	Common	1,250,000	25,000	23,875	25,000
Mar. 20	Electric Shareh	Conv. pfce	250,000	23,875	None	None
June 11	Central States	Conv. pfce	100,000	9,450	9,450	None
July 3	Central States	Conv. pfce	15,500	1,487	1,487	None
July 23	Central States	Common	384,616	20,000	None	20,000
July 26	Shenandoah	Common	5,000,000	52,500	[b] 12,500	40,000
July 26	Shenandoah	6% opt. pfce	1,000,000	50,000	[b] 50,000	None
July 29	Electric Shareh	Conv. pfce	10,000	1,050	1,050	None
Aug. 19	Blue Ridge	Preference	1,000,000	50,000	[c] 50,000	None
Aug. 19	Blue Ridge	Common	7,250,000	77,500	[c] 15,000	62,500
Aug. 27	Blue Ridge	Preference	212,500	10,944	[d] 10,944	None
Aug. 27	Blue Ridge	Common	212,500	4,250	[d] 4,250	None
Sept. 5	Shenandoah	6% opt. pfce	750,000	27,500	None	37,500
Sept. 5	Shenandoah	Common	750,000	25,000	None	25,000
Sept. 15	Central States	Deb. 5½–1954	23,563	23,563	23,563	None
Total, 1929				413,657	203,657	210,000
Aggregate total, 1928–29.				492,285	266,120	226,165

[a] Public Examination, Central States Electric Corporation, Commission's Exhibits Nos. 1233 and 1285.
[b] Sold to public for common, $17,500,000; preference, $50,000,000; total, $67,500,000.
[c] Sold to public for common, $20,000,000; preference, $51,500,000; total, $71,500,000.
[d] By Manufacturers Trust Co.

[708] Op. cit. supra, note 666, Commission's Exhibit No. 1233.

[709] For a brief description of the development of Central States during this period see Ch. I of this part of the report, pp. 5–6.

[710] See op. cit. supra, note 666, Respondent's Exhibit No. A.

high market prices prevailing late in 1928 and in 1929 before the stock market crash.[711]

The task of an investor attempting to appraise the investment merits and rights of his Central States security was rendered even more difficult by the numerous new securities issued in a short time. In a period of less than a year and three-quarters, the Central States group of companies made public offering of 17 new issues of securities in addition to a number of issues which it distributed to companies in the group.

Accompanying the great volume of security offerings in this period of a year and three-quarters were numerous trading and distribution accounts operated in the various securities of the investment companies in the group as well as in the principal underlying asset of Central States, North American common stock.[712] Included in these trading

[711] American Cities Power & Light Corporation at formation in October 1928 purchased from Central States 170,000 shares of North American common stock at a market price of $73¾ per share for a total of approximately $12,500,000 (id., at 12763).

Electric Shareholdings Corporation at organization in March 1929 purchased from Central States 66,625 shares, or a total of some $6,800,000, and a similar amount from Hydro-Electric Corporation, its other sponsor (id., at 12938–40, and Commission's Exhibit No. 1246).

While Shenandoah Corporation did not purchase North American common stock at its formation, it did issue its own securities in exchange for $20,000,000 of Central States common stock taken at a market value of $52 a share, and in addition Nasco sold 96,154 shares of Central States common stock to Shenandoah for approximately $5,000,000 in cash. Large amounts of Shenandoah stock were also issued in exchange for stock of the other sponsor. The Goldman Sachs Trading Corporation (id., at 13193–201, and Commission's Exhibits Nos. 1261 and 1262).

Blue Ridge Corporation, formed in August 1929, purchased 68,423 shares of North American common stock at $167 (id., at 13236) per share for a total of some $11,400,000. This block was purchased from four of Mr. Williams' personal holding companies (Federal Utilities Company, Utility Securities Company, Electric Investment Company, and New Empire Corporation) (id., at 13310–7, and Commission's Exhibit No. 1304).

[712] The extent of these purchases and sales in trading and distribution accounts in the various securities of companies in the group by persons and companies affiliated with or forming part of the group which were discussed in the public examination of Central States Electric Corporation is indicated by the following exhibits and in the testimony relating thereto (op. cit. supra, note 666):

Security	Earliest date of activity in an account	Latest date of activity in an account	Commission's exhibits
North American common stock	May 1924	1935	1208, 1212, 1214, 1216, 1217, 1314, 1317, 1321, 1322, 1325, 1326.
Central States:			
5% deb. 1948	Jan. 1928	May 1930	1223.
5½% deb. 1954	Sept. 1929	May 1930	1238.
6% pfd. with warrants (of April 1928).	April 1928	April 1929	1225.
Conv. pfd. (of Sept. 1928)	Sept. 1928	Oct. 1929	1228, 1253, 1254, 1255, 1258.
Conv. pfd. (of June 1929)	June 1929	Oct. 1929	1235, 1253, 1254, 1255, 1258.
Common stock	1927	1936	1208, 1209, 1252, 1334.
American Cities: Power & Light Units of—			
Class A and Class B	Nov. 1928	April 1929	1229, 1231.
Class A stock	June 1929	Jan. 1931	1229, 1231.
Class B stock	Nov. 1928	1933	1230, 1232, 1314, 1354.
Electric Shareholdings:			
Conv. pfd	Mar. 1929	Aug. 1929	1248, 1249, 1250, 1251.
Common stock	Mar. 1929	April 1931	1243, 1251, 1276, 1277, 1354.
Shenandoah:			
Conv. pfce	July 1929	July 1930	1280, 1314, 1335, 1339, 1340, 1343, 1345.
Common stock	July 1929	Sept. 1931	1280, 1314, 1335, 1336, 1341, 1342, 1343, 1344, 1354.
Blue Ridge:			
Conv. pfce	Aug. 1929	Oct. 1930	1314, 1346, 1348, 1349, 1350, 1352, 1353.
Common stock	Aug. 1929	Aug. 1930	1314, 1346, 1347, 1349, 1351, 1352, 1353, 1354.

activities were not only syndicate trading operations in connection with the original issuance of new securities but also various market trading and retail distribution activities. These operations were conducted by the investment bankers for the new security issues, by Mr. Williams through Nasco, by Central States Electric Corporation, and by the other sponsors of the newly formed investment companies in the group. In all but one of the total of 15 security issues outstanding [713] in 1928 and 1929 of Central States Electric Corporation and of the other four companies in the group, substantial trading on and off the stock exchanges was engaged in at one time or another in these two years by persons and companies affiliated with or forming part of the group.[714] A compilation of the estimated dollar volume of those trading accounts of affiliated persons and companies for which trading figures are available indicates during the two years, 1928–1929, an aggregate of almost $200,000,000 of purchases of these securities and of over $145,000,000 of sales.

That these trading activities constituted a powerful force tending to lift market prices [715] during the major period of security distribution by the group, is evidenced by the heavy concentration of purchases on the stock exchange without the counterbalancing effect of sales on the stock exchange.[716] Based on this estimated dollar volume, over 90% of

[713] In the 7% first preferred stock of 1912 there were purchases by Central States Electric Corporation in 1929, but no sales (op. cit. supra, note 666, Commission's Exhibit No. 1253).

[714] While trading accounts were not active in substantial amounts in every issue at one time, a number of them were often active together and frequently constituted a substantial proportion of total market transactions in the securities involved, particularly total market purchases. For example, during the month of September 1929, the month of the issuance of $25,000,000 of debentures by Central States Electric Corporation and shortly prior to the stock market crash of October 1929, trading accounts were in operation in 12 out of a total of 15 issues then outstanding in the Central States Electric Corporation group of companies, with no mention of these accounts being made in the offering circular (op. cit. supra, note 666, Commission's Exhibit No. 1237).

[715] The effect of the market rise in the securities of new investment companies upon the market value of Central States Electric Corporation's assets is illustrated by the increase in market value of Central States original investment in 80% of the common stock (1,600,000 shares of Class B stock) of American Cities Power and Light Corporation (op. cit. supra, note 666, at 12755, et. seq. and Commission's Exhibits Nos. 1242, 1247, and 1252):

			Approximate price per share
10/31/28	cost	$16, 165, 000	10
12/31/28	market	44, 800, 000	28
7/31/29	market	94, 000, 000	58¾

Central States' large holdings in the common stock of Electric Shareholdings Corporation and Shenandoah Corporation also had substantial rises in market value in a short time (Public Examination, Central States Electric Corporation, at 13584–9, 13219, and Commission's Exhibits Nos. 1251, 1252, and 1344).

[716] The extent of the influence of these trading accounts in contributing to the rise in the market price of particular securities as opposed to other factors present in 1928 and 1929 was at times in dispute at the public examination of Central States Electric Corporation. However, that these trading accounts frequently represented a substantial proportion of the total monthly market purchases, constituted in many instances a majority or more of the total daily market purchases and were concentrated in their effect on market purchases, and not on market sales, clearly indicates that these trading activities were often a substantial contributing factor in the extraordinary increases in the market prices of the securities involved.

total purchases were made on the stock exchange, while almost 90% of the total sales were made off the stock exchange,[717] as follows:[718]

	Bought			Sold		
	On the exchange	Off the exchange	Total	On the exchange	Off the exchange	Total
1928	$17,969,000	$4,629,000	$22,598,000	$516,000	$22,160,000	$22,676,000
1929	161,193,000	14,846,000	176,039,000	18,735,000	105,895,000	124,630.000
			198,637,000			147,306,000

Since investors during these two years were not informed of these various trading activities in the offering circulars or otherwise, as far as appears in the record, their security purchases over the period were made without knowledge of a substantial factor. Even if those activities had been disclosed, it would have been difficult to appraise their effect.

(d) Trading Activities and Conversion Features of Preferred Stocks

The relation of trading activities to the sale of securities and their connection with other complications is illustrated by the trading activities related to the two convertible preferred stock issues of September 1928 and June 1929. Prior to and at the time of the issuance of each of these convertible preferred stock issues there was substantial trading in Central States common stock by Nasco, and in 1929 there was in addition substantial trading by Central States in the preferred stocks themselves.

[717] Thus less than 10% of purchases were made off the exchange and only slightly more than 10% of sales were made on the exchange.

[718] These figures are based upon the estimated dollar amount of total purchases and sales broken down between purchases and sales on the exchange and those off the exchange in trading in the following securities:

	1928		1929	
	Purchases	Sales	Purchases	Sales
North American common stock	$12,790,000	$13,217,000	$9,167,000	$443,000
Central States deb. 5's of '48 and 5½'s of '54	4,702,000	4,619,000	2,607,000	2,651,000
Central States pfd. stocks of September 1928 and June 1929	2,669,000	2,408,000	19,617,000	10,516,000
Central States common stock	1,012,000	447,000	32,809,000	40,131,000
American Cities Power & Light Corp. Units, Class A and Class B	1,425,000	1,985,000	26,282,000	24,713,000
Electric Shareholdings			8,130,000	10,735,000
Shenandoah pfce. and common stocks			49,001,000	15,643,000
Blue Ridge pfce. and common stocks			28,426,000	19,798,000
	22,598,000	22,676,000	176,039,000	124,630,000

Total purchases	$198,637,000
Total sales	147,306,000

(For sources see supra, note 712.)

This trading was closely related to the convertibility of the preferred stocks, a feature based upon changes in corporate law which were secured by Central States. It will be recalled that the preferred stock issue of April 1928 was not convertible but carried warrants to purchase North American common stock. Central States at this time was not able under the law of Virginia, the state of its incorporation, to issue securities with conversion features or a variety of other rights and privileges that it desired. The State of Virginia, according to Louis E. Kilmarx, vice president and treasurer of Central States,[719] "had an old antiquated law that did not provide for a certain type of securities the corporation wished to issue, * * * and did not permit the issue of the class of securities that might be termed a convertible class, which we had in mind." [720] As a result, the corporation became one of the "prime movers" [721] in having the corporation laws of the State of Virginia amended.[722] M. W. Tuttle, of Sullivan & Cromwell, New York counsel for the company, stated at the Board of Directors meeting of July 5, 1928 "that primarily at the instance of the corporation, the corporation laws of Virginia had been amended * * * to permit Virginia corporations in their charters or amendments thereto to provide for the issue of preferred stock in series with certain specified variations between the series as to dividend rates, redemption price, preference on dissolution, sinking-fund provisions, conversion and stock-purchase-right provisions, and so forth, as might be determined by the board of directors * * *." [723] With 97% of the common stock owned by Mr. Williams in 1928 and a negligible voting power existing in the preferred stock,[724] the corporation quickly amended its own charter so as to give to the board of directors the full power permitted by the newly amended corporation law of Virginia.[725]

In September 1928, within two months after this amendment, Central States took advantage of the amended Virginia law and issued $10,000,000 of preferred stock convertible into the common stock of Central States on the basis of one share of common stock for each $118 par value of preferred stock, at a time when the common stock of the company was selling at $112 a share.[726] This feature, which was of decided importance in attracting purchasers of the preferred

[719] Op. cit. supra, note 666, at 12353.

[720] Id., at 12687.

[721] Id., at 12690.

[722] A fee was paid to a Richmond, Virginia, law firm in connection with the passage of this legislation (id., at 12691, and Commission's Exhibit No. 1227).

[723] Id., at 12688–9.

[724] See note 688, supra, for Mr. Williams' holdings of the common stock in 1928. The total voting power of the only issue of preferred stock with voting rights was less than 7%. None of this preferred stock was owned by Mr. Williams.

[725] Op. cit. supra, note 666, at 12689–90.

[726] Id., at 12704–6, and Commission's Exhibit No. 1228.

stock,[727] was emphasized in the offering circular.[728] The preferred stockholder also had the right to take payments of dividends in common stock at an attractive ratio.[729]

An obstacle to a clear appraisal of this preferred stock offering lay in the holdings and activities of Mr. Williams in the common stock of Central States.[730] The market price of the common stock of Central States had risen almost 300%, from a market price of about $30 a share at the beginning of 1928 to a market price of $112 a share shortly prior to the public offering in September 1928,[731] while the underlying net asset value of a share only doubled during the entire year.[732] From a discount of 20% below asset value at the beginning of 1928, the price of Central States common stock rose to a premium of almost 100% above asset value by the end of 1928.[733] This strong rise in the market price of Central States common stock occurred in a market where the floating supply was "obviously" very limited.[734] Only 35,000 shares of the common stock of Central States were outstanding in the hands of

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[727] In this respect Mr. Forrestal testified (id., at 12707):

Q. So that at that time one of the selling features of this stock is the fact that it is convertible at $118 per share——
A. And selling at $112; that is right.
Q. Convertible at $118, and it is selling at $112. So that it is right in the range, isn't it?
A. Yes.
Q. There is a possibility of its being convertible right away?
A. It is an attractive conversion. I would say.
Q. And that would have an effect on the sales, wouldn't it?
A. I think so.
Q. It would help sell it, make it more attractive.
A. I think so.

[728] The offering circular for the $10,000,000 preferred stock issue of September 5, 1928, pointed out in its heading that dividends were "payable quarterly in common stock of the company at the annual rate of one-sixteenth of a share of common stock per share of this preferred stock, or, at the option of the holder, in cash at the annual rate of $6 per share," and that the preferred stock was "convertible, at the option of the holder, into common stock of the company at the rate of one share of common stock for each $118 par value of this preferred stock."

The circular further pointed out that the "present market value, as evidenced by quotations on the New York Curb Market, is approximately $112 a share" and that "dividends are now being paid on this stock at the annual rate of $1 per share in cash and one-tenth of a share in common stock of the company" (op. cit. supra, note 666, Commisssion's Exhibit No. 1228).

[729] Op. cit. supra, note 666, Commission's Exhibit No. 1228.

[730] These were not disclosed in the offering circular (id., at 12707–18, and Commission's Exhibit No. 1228).

[731] Id., at 12712. Central States common stock had a market price of $24 a share as of December 31, 1927 (id., Commission's Exhibit No. 1206).

[732] From approximately $30 to $60 a share taking the securities of American Cities Power and Light Corporation at their asset value (op. cit. supra, note 666, Commission's Exhibit No. 1206).

[733] Op. cit. supra, note 666, Commission's Exhibit No. 1206.

[734] Id., at 12709. Although there were only 35,000 shares outstanding in the hands of the public, the new issue presented the maximum possibility of 100,000 shares of preferred stock being converted to the common stock. Mr. Forrestal stated that he did not realize that there was such a small amount outstanding and that this factor would have to be disclosed today (id., at 12709–10).

the public and the balance of over a million shares were held by Mr. Williams. During the year 1928 Mr. Williams purchased 9,700 shares of this common stock, of which approximately 7,000 shares, or almost one-half of the total stock exchange purchases, were purchased by Nasco on the stock exchange while only approximately 3,000 shares were sold by it on the stock exchange.[735] Without attempting to appraise the precise influence of these trading activities of Mr. Williams in the tripling of the market price of Central States common stock in 1928, it is clear that his operations constituted a substantial factor in the price of that common stock and hence in the sale of the preferred stock. Thus the corporation used the recently added conversion feature as one of the major inducements to sell a preferred stock issue at a time when an accurate appraisal of the benefits from this feature was being impeded, if not prevented, by the activities of Mr. Williams in the common stock.

The offering circular used for the preferred stock issue of June 1929 like that for the issue of September 1928, stressed the feature of convertibility,[736] and pointed out the closeness of the market price of the common stock to a point at which conversion would be profitable. During the first eight months of 1929 the common stock of Central States Electric Corporation tripled in market value,[737] with Nasco's purchases of approximately $33,000,000 over the year 1929 constituting a substantial proportion of the total exchange purchases and its sales a negligible amount of total exchange sales.[738] A relatively small amount of common stock of Central States was outstanding in the hands of the public since at the beginning of 1929. Mr. Williams owned 96% of the common stock of Central States and in July 1929 his holdings still amounted to 90% of the total outstanding.[739]

Moreover, an additional element of complexity connected with the feature of convertibility was injected into the situation in 1929.[740]

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[735] Op. cit. supra, note 666, at 12712–21.

[736] The offering circular for the issue of June 11, 1929, emphasized the right of the investor to receive quarterly dividends payable in common stock of the company at the annual rate of one-sixteenth of a share of common stock per share of preferred stock and the latter's convertibility into a share of common stock at the rate of one share of common stock for $118 par value of this preferred stock. The circular also pointed out that the present market value of the common stock on the New York Curb Exchange was $110 per share (op. cit. supra, note 666, Commission's Exhibit No. 1235. For offering circular of the issue of September 1928, see id., Commission's Exhibit No. 1228).

[737] The market price of the common stock of Central States Electric Corporation rose some 15 times from January 1, 1928, to August 30, 1929. A share of this stock had a market value of $114 a share by December 31, 1928, and had reached a high of $492 a share by August 30, 1929, after adjusting for stock dividends of 100% and 200% (op. cit. supra, note 666, Commission's Exhibit No. 1206. For common stock dividends see *Poor's Public Utility Section* (1929) p. 1693 and *Poor's Government and Municipal Section* (1930) p. 1086).

[738] Nasco's purchases of Central States common stock constituted approximately 43% of the total exchange purchases in January, 96% in February, 31% in March, over 80% in April, 26% in May, 23% in June, and so forth through the year with an average of 38% for the year. The rises in the market price of the common stock of Central States Electric Corporation coincided with Mr. Williams' operations in that stock, the sharpest rises occurring as Mr. Williams admitted, when he was most active in the stock (op. cit. supra, note 666, at 13124–7, 13344, and 13346). Sales by Nasco of approximately $40,000,000 during 1929 were almost entirely off the exchange. (See id., Commission's Exhibits Nos. 1209 and 1252.)

[739] Op. cit. supra, note 666, at 13068, 13315, and Commission's Exhibit No. 1205.

[740] The stock dividend and stock split-up policy engaged in by Central States constantly changed the outstanding common stock and altered the formula for calculating the con-

From February to October 1929 Central States engaged in substantial[741] trading in and repurchases of the preferred stocks which were convertible into its common stock.[742] This activity was apparently designed, among other things, to prevent the exercise of the rights of conversion of the preferred stocks, which then stood as a threat to the market price of the common stock. Within five months after Central States had raised $10,000,000 through the sale of its preferred stock in September 1928, and for four months before and after June 11, 1929 (the date of sale of an additional $10,000,000 of convertible preferred stock) Central States was trading in and reacquiring approximately $5,000,000 par value of the shares of these particular issues at a cost of more than $9,000,000. The assets of the company were thus used to repurchase senior securities at prices far in excess of the liquidation values of these securities, and in excess of the asset value of such common stock as the company would have had to issue upon exercise of the conversion privileges. Since this trading and reacquisition activity occurred between annual reports which were issued as of the end of the year, the investor would have no means of learning of its existence, particularly since the activity was not mentioned in the offering circular.[743] Furthermore, the amount of senior securities outstanding at any one time was thus constantly being increased and decreased at the instance of the Board of Directors without the knowledge of shareholders, and the assets and earnings applicable to a particular preferred stock issue were subject to unpredictable and unknown shifts and changes.[744]

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version privilege (see infra, this chapter). The outstanding stock in 1929 represented an increase, through split-ups and rights to subscribe, of 120 times the stock outstanding in 1923. Also the company in 1928 adopted the policy of declaring a dividend each year of 10% of its outstanding stock (op. cit. supra, note 666, Commission's Exhibit No. 1205).

[741] The volume of Central States' purchases constituted almost 60% of the total shares traded in the exchange in one issue, and over 45% of the total shares traded in the other issue for the 9-month period. Total purchases in the two issues amounted to almost $16,000,000 and total sales to approximately $7,000,000 (id., Commission's Exhibits Nos. 1254 and 1255).

[742] For more detailed discussion see Ch. III, pp. 960–5.

[743] See offering circular for the preferred stock issue of June 1929 (op. cit. supra, note 666, Commission's Exhibit No. 1235).

[744] Another example of the constant change in the capital structure of Central States without disclosure to the public purchasers of its securities is found in 3 cases in which a substantial issue of senior securities was sold to the public without any disclosure in the original circulars of the immediate possibility of further issues. In each case within a short time an additional issue was made and sold to the bankers selling the original issues in an amount approximately sufficient to cover their short position. These original issues and the subsequent issues were as follows:

Date	Company		Shares
Sept. 5, 1928	Central States	Op. div	100,000
Oct. 4, 1928	Central States	Op. div	10,000
Nov. 14, 1928	American Cities	Units Pfd. A	400,000
		Units Com. B	400,000
Feb. 6, 1929	American Cities	Units Pfd. A	25,000
		Units Com. B	25,000
Mar. 20, 1929	Electric Shareholdings	Common	1,250,000
		Conv. pfce	250,000
July 29, 1929	Electric Shareholdings	Conv. pfce	10,000

(Op. cit. supra, note 666, at 12729–43, 12751–3, 12760–1 and 13004 et seq. and Commission's Exhibits Nos. 1228, 1239, 1240, and 1249.)

(e) Pyramiding of Investment Companies in Group

The pyramiding of investment companies which was engaged in by Central States in 1928 and 1929 also tended to place an intelligent appraisal of the earnings and worth of the securities issued by the various investment companies in the group beyond the capacity of the investing public. In this respect Mr. Williams testified: [745]

Q. Well, the fact remains that you have here in Central States a holding company superimposed upon a lot of other holding companies, and from an investment point of view in Central States, you are probably a long ways away from the values in the system, aren't you?

A. You mean a long ways away from the operating company.

Q. Yes. How can you tell what the values are? How can you be so definite and certain with intermixed here so many holding companies so far removed from your ultimate pillars of investment; namely, your operating companies?

A. Well——

Q. You get pyramiding on pyramiding and on pyramiding.

A. Well, I admit that was a hard thing to analyze * * *.

Thus, the earnings of the North American common stock,[746] the principal asset of the system, reached the top company, Central States Electric Corporation, in varying ratios depending on the leverage from the senior securities existing in the particular investment company of the group, in which the block of North American common stock was held.[747] For example, at the end of 1929 approximately 85% of the earnings of the block of North American common stock held by Blue Ridge Corporation, would, after allowing for dividends to the senior securities of Blue Ridge Corporation, accrue to Shenandoah Corporation.[748] In the case of Shenandoah Corporation, however, after allowing for payments to its senior securities, only 45% of these earnings coming from Blue Ridge Corporation and from Shenandoah Corporation's own holdings of North American common stock would be passed

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[745] Op. cit. supra, note 666, at 12341. Mr. Williams was unwilling to admit that the price of Central States common stock was out of line with other stocks in 1929, testifying (id., at 12342, et seq.):

Q. Then that $680,000,000, if it is realistic, would have to be realistic in terms of those ultimate values of the operating companies?

A. Right. If you are taking it on the basis of liquidating value.

Q. Well, take it on the basis of investment.

A. Well, take operating companies at that time. They were selling higher than the stock of operating companies that were ever sold.

Q. How about on the basis of return of investment?

A. They were selling on that basis of 40 and 45 times the earnings, which would be about what?

Mr. JOHNSON. 2¼ percent.

Q. Well, on the basis of the earnings—perhaps you aren't prepared to answer this, Mr. Williams—on the basis of the earnings in the underlying properties in the system, is this $680,000,000 out of line? Is that fantastic?

A. Well, only to the extent that the prices of all stocks were out of line in 1929.

[746] The North American Company in 1929 was itself a utility holding company with senior securities outstanding. Its earnings were derived from operating companies which also had senior securities outstanding. (*Moody's Manual of Investings, Public Utility Securities*, 1930, p. 2397.)

[747] See supra, Chart 8, p. 1684, and op. cit. supra, note 666, Commission's Exhibit No. 1207 and Respondent's Exhibit No. A.

[748] I. e., since Shenandoah held roughly 85% of the common stock of Blue Ridge Corporation on December 31, 1929 (Reply to the Commission's questionnaire for Blue Ridge Corporation, Pt. VIII). See also Chart 8, p. 1684.

on to Central States.[749] To the earnings of North American common stock which had been received by Central States Electric Corporation from Blue Ridge Corporation and Shenandoah Corporation as above described would be added the earnings received directly from Central States' own holdings of a substantial amount of North American common stock and its 70% interest (after dividends for senior securities) in the block of North American common stock held by American Cities Power & Light Corporation. Thus the earnings from the major investment of the system would be reflected in the top investment company, Central States, in different percentages and with varying leverage,[750] the determination of which would involve intricate mathematical calculations, even if all the information were available.

(f) Circular Ownership and Cross Holdings in Group

Further complications were added because, beginning in 1929, Central States Electric Corporation and Shenandoah Corporation held substantial blocks of each other's common stock. In addition, there was circular ownership between Central States Electric Corporation, Shenandoah Corporation, and Blue Ridge Corporation. Central States held the common stock of Shenandoah Corporation, which, in turn, held common stock of Blue Ridge Corporation, which, in turn, held common stock of Central States Electric Corporation.[751] The effect of such cross and circular holdings is to duplicate values and to inflate the amount of earnings and of assets unless eliminations were made.[752] To eliminate the improper effect of these cross holdings and to reflect the true underlying values of the securities, a complicated formula, submitted by the accountants, was first authorized December 31, 1929, and had to be amended twice thereafter.[753] However, this

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[749] I. e., since that was the approximate percentage of Central States' ownership of Shenandoah Corporation's common stock (Reply to the Commission's questionnaire for Shenandoah Corporation, Pt. VIII).

[750] For a discussion of leverage and its effect see Pt. One (House Doc. No. 707, 75th Cong.), pp. 28–9 and Ch. I of this part of the report, pp. 12–13. See also text of Central States Annual Report for 1929 which considered the high leverage ratio of the common stock "advantageous."

[751] Op. cit. supra, note 666, Commission's Exhibits Nos. 1207 and 1356 and Respondent's Exhibit No. A.

[752] In respect to the attitude prevailing in 1928 and 1929 towards the simplification of capital structures in this respect, Clifford F. Stone, president of Shenandoah Corporaton and Blue Ridge Corporation, testified (op. cit. supra, note 666, at 13290):

Q. Let's get away from the personal point of view down to the investor's point of view.

Don't you think as you look back, Mr. Stone, that it is sound and only proper that a corporation should have such a capital structure that any investor can very easily figure out the relative value of his particular share of stock?

A. Well, I don't know. I don't recall that that particular consideration, Mr. Smith, was a factor of any considerable extent in our accounting department or organization in any of our companies.

Your question, it seems to me, bears directly on the calculation of the asset values and I may say that in 1929 asset value was not by any means the most important element in our minds in evaluating a stock of this type.

Q. You mean the net liquidating asset value of the stock was not primary in your mind. Is that right?

A. Well, I would say it was a factor, but not a primary factor.

[753] Id., Commission's Exhibit No. 1266. The resolution of December 31, 1929 provided (derived from supplementary information supplied the Commission for Central States Electric Corporation (item 13)):

Resolved, That the officers of the Corporation, in collaboration with counsel and accountants, be authorized and instructed to devise a formula for use in valuing assets

formula was of such a complicated nature as to be beyond the ken of the ordinary investor. Even the president of the company admitted his incapacity to apply properly this formula. Concerning the effect of the organization of Shenandoah Corporation and of Blue Ridge Corporation in July and August of 1929, respectively, Mr. Stone, president of these companies, stated:[754]

Q. There is no question about the fact that Shenandoah and Blue Ridge complicated the capital structure of the Central States system, is there?

A. Well, the formation of these companies added to the size of the picture and added certain features to the financial structure, looking at it from top to bottom.

Q. It complicated it so much that the auditors had a hard time working out a formula, didn't they, to determine the actual value of the cross holdings in the system?

A. Yes.

* * * * * * *

Q. Could you work it out?

A. I say it would be hard for me, or for any accountant probably it would be difficult.

* * * * * * *

Q. Wouldn't it be impossible for the average investor to work out the actual value of the respective holdings of Shenandoah and Central States after the formation of Shenandoah, with their cross holdings?

A. Giving effect to that cross holding reserve formula?

Q. Yes.

A. I should say it would be difficult for the average person to do it. It would be difficult for me to do it, I should say.

Q. You were president of the company and you said it would be very difficult for you to do it?

A. Difficult in the sense that is the type thing that I, as president of the company, did not undertake to do and would not undertake to do. I looked upon that as an accounting matter to be handled by the accountant, the same as the accountants handled a great many other features of the corporation's affairs. I didn't undertake to do it and wasn't capable of doing it personally.

(g) Stock Dividends

Not only did it become virtually impossible to determine the value of the assets of Central States Electric Corporation, but a realistic understanding of the company's actual earnings was difficult because of the stock dividend policies that were followed by Central States and other investment companies in the group and by The North American Company.[755] Mr. Williams had been instrumental in 1923

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of this Corporation, having for its purpose the creation of a reserve estimated to adjust the effect of any "cross-holding" of stock represented by a substantial interest of this Corporation in the common stock of another company which in turn has a substantial interest in the common stock of this Corporation; and

Resolved, That the officers and accountants of this Corporation be authorized and instructed to apply and make use of such formula as may be devised pursuant to the foregoing resolution.

[754] Op. cit. supra, note 666, at 13283–5.

[755] The stock dividend policy of The North American Company had other complicating factors. Since subsequent to 1922 Central States' principal asset lay in the common stock of The North American Company, which from 1923 had declared stock dividends only, the cash earnings of Central States became inadequate to meet the interest and dividend requirements on its increasing amount of senior financing. However, for the two years,

in inaugurating a 10% periodic stock dividend policy by The North American Company, which was later adopted by Central States itself and the other investment companies in the group [756] with the result that for the period 1927 to 1935 stock dividends constituted almost the entire income of Central States,[757] with common stock dividends from The North American Company as the most important single item.[758]

One problem presented by the payment of periodic stock dividends is that such payment tends to establish a regular stock dividend rate, the market value of which when paid may greatly exceed the amount of the actual earnings of the company as was the case in respect to the North American Company. Thus the securities of the company paying stock dividends will appear "unduly attractive to the unintelligent buyer, who is deceived by the high cash value of the current payments in stock" since it "requires some insight into corporate accounting methods to realize the true significance of such stock dividend payments." [759] The ordinary stock dividend policy may also create a vicious circle of inflation, since the higher the market price the greater the apparent value of the stock dividends paid which in turn may lead to a higher market price of the stock itself.[760] An even greater disproportion between the market price of common stock dividends and actual earnings tended to exist in respect to the

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1927 and 1928, Central States paid out in cash dividends approximately $1,500,000 on its preferred stocks and approximately $2,200,000 on its common stock (op. cit. supra, note 666, at 12630). Central States also paid cash dividends on its common stock in 1929 and 1930 (reply to Commission's questionnaire for Central States Electric Corporation, Pts. II and V [item 39]), of which sum roughly 97% went to Mr. Williams by virtue of his common stock holdings in that percentage.

Yet to pay cash dividends on its outstanding common and preferred stock Central States in one instance at least raised funds by selling preferred stock to the public. The $10,000,000 raised from the issue of preferred stock on September 5, 1928, was used not only to buy more North American common stock, but was also used, as Mr. Kilmarx admitted, "to pay dividends on common stock to the extent of $2,000,000" (op. cit. supra, note 666, at 12633–4). The offering circular for this issue stated "the proceeds * * * are to be used to acquire additional investments, and for other corporate purposes" (id., Commission's Exhibit No. 1228).

[756] Id., at 12528 et seq. and Commission's Exhibits Nos. 1205, 1239, 1240, 1243, 1259, 1267, and 1288.

[757] For the period 1927–35 Central States' ordinary income from stock dividends, taken at their market values at or about the record dates, was approximately $49,500,000 (before appropriations of some $28,000,000 in reduction of the book values of these stock dividends), while its cash income was only approximately $5,000,000. Over the period its interest payments on funded debt and other similar items were over $17,000,000, its cash dividend payments on preferred stocks roughly $5,000,000, and its cash dividends on common stock $8,500,000 (reply to Commission's questionnaire for Central States Electric Corporation, Pt. II).

[758] Op. cit. supra, note 666, Commission's Exhibit No. 1237.

[759] Graham, Benj., and Dodd, D. L., *Security Analysis* (1934), pp. 344–5, which shows that from 1924 through 1932 the market value of the 10% periodic stock dividends of The North American Company exceeded the earnings per share of that company each year and in 1929 by more than twice the amount of the actual earnings of the company.

[760] As was stated by Messrs. Graham and Dodd, the result of such an arrangement is "deceptive and supplies an unwholesome impetus to riotous speculation as well as to thoughtless investment." The relation of this policy to investment companies, and particularly to Central States Electric Corporation, is pointed out as follows (id., at 346–7):

> *Example of Vicious Pyramiding on Stock Dividends.*—During the boom years periodic stock dividends were made the medium of an especially vicious pyramiding of reported profits. An operating company would pay out stock dividends with a market value more than its current earnings, and in turn an investment trust or holding company would report these stock dividends as income in an amount equal to the market value.

common stock of The North American Company, Central States, and other investment companies in the group because of the strong influence of the trading and distribution activities engaged in by Nasco, Central States, and other affiliated companies or persons, already mentioned.

The treatment of stock dividends received by Central States in 1928 and 1929 during the major period of the sale of securities by the group tended to reflect these distorting influences, since stock dividends received by Central States were treated as income and were carried at their approximate market value immediately following the record date for each dividend,[761] practices not generally followed today.[762] While that part of the portfolio acquired through purchases was carried at cost, the other part received as stock dividends was carried at market prices prevailing at the time of payment, thus giving effect to stock dividends as actual earnings when in fact they had not been realized in cash. Moreover, the dangers existing from such treatment of periodic stock dividends were greatly augmented in respect to Central States because it was the top company in 1929 of a pyramided system of a number of related companies paying periodic stock dividends.[763] The importance of this treatment of stock dividends is illustrated by the offering circular of Central States for the use of $25,000,000 of debentures in September 1929 which showed the company's annual interest requirement after the new issue to be $2,300,000 and the income available to meet these charges to be $19,300,000. Yet the detail respecting this available income showed that cash dividends represented only $800,000, that approximately $12,000,000 came from stock dividends (largely from taking the common stock of The North American Company in income at its market value following the record date for each dividend) and that $7,600,000 came from the uncertain item, profit on the sale of securities.[764]

(h) Lack of Relation of Asset Value to Market Prices

As a result of these financing transactions, rising security markets, various trading operations, and concentrated distribution activities by

[761] Subsequently, however, namely, as of December 31, 1929, Central States changed this method of valuing stock dividends by setting up a reserve for the excess of their book value over their market value at that time. In 1930 and subsequent years a complete reserve was set up against stock dividends as income. While Mr. Kilmarx, president of Central States, refused to admit that this treatment of valuation of stock dividends was an unsound method, was misleading, or that the corporation had in effect admitted the unsoundness of the practice by its later change in method, he did not contend that it was standard practice today (op. cit. supra, note 666, at 12639).

[762] Over three-quarters of a group of 69 investment companies examined for their accounting practices did not treat stock dividends as income over the period 1927–35. For a more complete discussion of Central States in this respect, see Ch. VI of this part of the report, Sec. I, B, 16, a. A common method prevailing at the time and today is to add shares received as dividends to the investment account at no value, thereby reducing the average cost of all the shares in the same security account.

[763] See supra, Chart 8, p. 1684.

[764] Op. cit. supra, note 666, Commission's Exhibit No. 1237. The offering circular for the issue of $20,000,000 of debentures of December 27, 1927, showed that the interest requirements after the issue would be $1,000,000, yet the cash dividends available in 1927 were only $55,500. The offering circular nevertheless indicated available earnings of about $5,000,000, of which over $4,000,000 was derived from taking the stock dividends of The North American Company at their market value when received, while $881,000 was "other income" (id., Commission's Exhibit No. 1222).

Harrison Williams and other sponsors of the investment companies in the Central States group and of other factors generally present in this 1928–1929 period,[765] the aggregate market price of all the outstanding security issues of Central States rose from $44,000,000 as of January 1, 1928 to over $730,000,000 as of August 30, 1929.[766] Of this increase in market value, less than $75,000,000 was attributable to new capital raised by the public sale of securities issues of Central States.[767] The success of Mr. Williams in achieving one of his objectives, namely, to increase the market price of Central States common stock, is illustrated by a comparison of the market behavior of that stock with the common stock of The Northern American Company, Central States' principal asset. A hundred dollars invested in 1923 in North American common stock would have represented a market value of about $1,650 by August 30, 1929, yet a hundred dollars invested in 1923 in the common stock of Central States would have had a market value of $53,991 as of August 30, 1929, or over thirty times as much as the hundred-dollar investment in the North American common stock.[768] The aggregate market price of all the outstanding Central States common stock alone rose to $680,000,000, or three times its underlying asset value—a premium of 200%.[769] Mr. Williams at this time owned approximately 90% of all the outstanding common stock, or a block of common stock with an aggregate market price of over $610,000,000.

Since the underlying net asset value was determined by marking down Central States' holdings of the securities of the other investment companies in the group to the asset values of such securities and taking all other securities at market,[770] its calculation does not take into account any inflation that may have existed in other than investment companies in the group, such as in the common stock of The North American Company. However, the securities of Central States were not sold on the basis of this underlying net asset value, but rather were sold on the basis of taking Central States' holdings of securities of affiliated companies in the group at their market values. Thus the circular for the $25,000,000 of debentures sold in September 1929 represented that Central States' assets at market value were in excess of $350,000,000 as of September 6, 1929. This figure obviously represented a substantial increase over the underlying net asset value of the Central States' assets, since seven days earlier, the date for which figures are available, more than 25% of the market value of its assets represented inflation traceable to carrying the securities of other com-

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[765] For a description of this period in investment-company history see Ch. I of this part of the report, pp. 2–17.

[766] Op. cit. supra, note 666, Commission's Exhibit 1206. The aggregate market value of the outstanding securities of Central States Electric Corporation and affiliated investment companies in August 1929 amounted to almost one billion dollars and represented a premium of about 2⅓ times the consolidated net assets of the companies in the group (id., Commission's Exhibit No. 1247).

[767] See supra, note 707.

[768] See Ch. I of this part of the report, pp. 16–17.

[769] By August 30, 1929, the assets of Central States were $253,700,000 at underlying asset values, of which $211,200,000 was applicable to the common stock (op. cit. supra, note 666, Commission's Exhibit No. 1206). This calculation was made by taking the securities of affiliated companies in the portfolio of Central States at their asset value and the remaining securities in the portfolio of Central States at their market values (ibid.).

[770] For an illustration of the premiums existing in the various companies in the System, see supra, Chart 8, p. 1684.

panies in the group at their market value instead of at their underlying net asset value.[771]

Chart 9 illustrates not only the many complexities that existed for the investor in the Central States group at about its peak size, September 30, 1929, but also the premium of some $420,000,000 which the market price of the common stock of Central States represented over its underlying net-asset value. Two-thirds of the total market value of the common stock of Central States was represented by this premium, which reflected not only its own premium in market price but also the premiums that existed in the market prices of the securities of the other investment companies in the group which were held directly or indirectly by Central States.[772] Chart 9 further illustrates the interlocking relations between the various companies in the group, the remoteness of Central States from the basic sources of earnings, the operating companies owned by The North American Company; and indicates how any inflation or distortion of earnings or market prices in any one of the underlying companies in the group would be carried into and magnified in the top company. Finally, it illustrates the numerous personal holding companies (New Empire Corp., Federal Utilities, Inc., Rector Utilities Corp., Columbia Utilities Corp., Electric Investment Corp., Utilities Securities Corp), as well as the distribution company (Nasco), which were owned by Mr. Williams and used by him in controlling the Central States system in 1929.[773]

(4) SUBSEQUENT EXPERIENCE OF CENTRAL STATES

It is clear that the major period of sale of securities of the company occurred under circumstances which obscured and distorted the investment merits of those securities and the real worth of the companies' assets and earnings. A number of factors—the marketing of securities, repurchase activities, trading accounts in the Central States stock in the various investment companies in the group and in the common stock of The North American Company, the payment and treatment of stock dividends, conversion privileges, pyramiding of companies—all resulted in the market prices of Central States securities having little relation to their underlying earnings or asset values. While it is not possible to state exactly the degree of causal relationship between these complicating factors and the collapse in 1929 and thereafter of the market and asset values of Central States' securities, nevertheless that they contributed to this collapse is beyond question.

With the general decline in values following the market collapse of 1929, the securities of Central States Electric Corporation experienced a severe shrinkage, both assetwise and marketwise. By 1932 the assets

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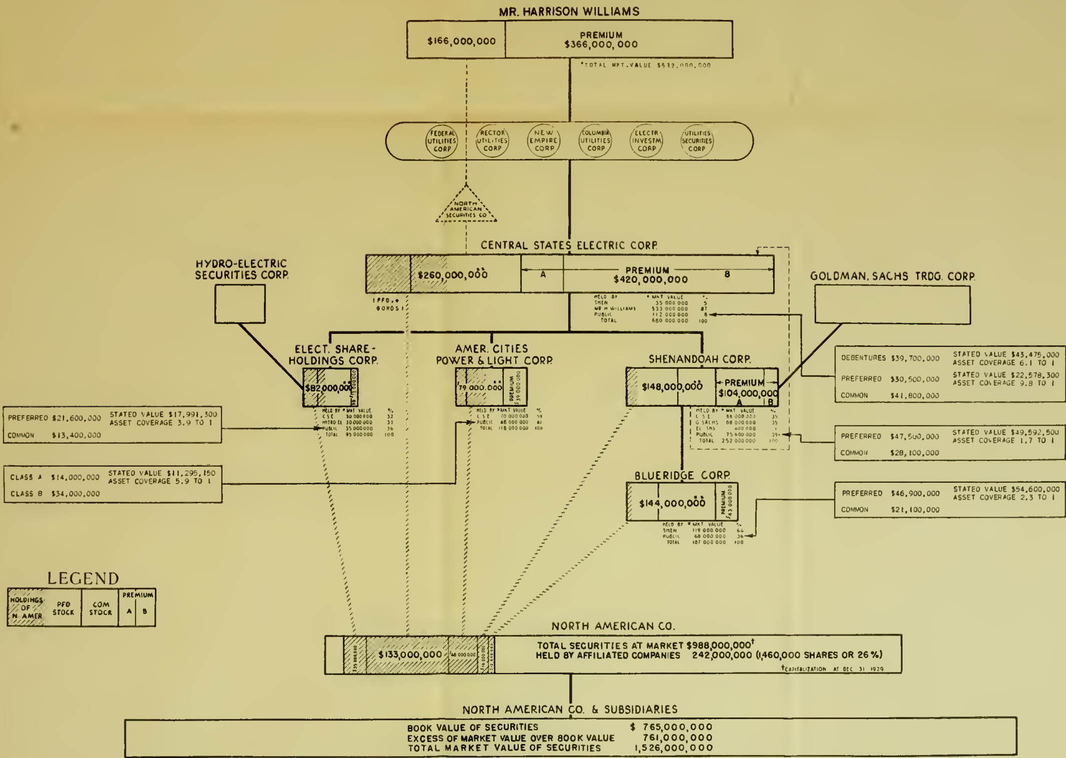
[771] As of August 30, 1929, Central States' assets at market value were approximately $346,500,000, while by taking the securities of affiliated companies in the group at their net asset value, its assets aggregated $253,700,000 (op. cit. supra, note 666, Commission's Exhibit No. 1206).

[772] This premium does not include, however, the premium from any excess of market value over underlying values of the outstanding securities of The North American Company and subsidiaries, the market value of which was approximately twice their book value at this time.

[773] A list of controlled companies from January 1, 1927, to December 31, 1936, was derived from supplementary information supplied the Commission for Central States Electric Corporation.

CHART 9

CENTRAL STATES ELECTRIC CORPORATION AND AFFILIATED GROUP OF COMPANIES
AS OF SEPTEMBER 30, 1929



* Mkt. Value Corporative Outstanding Sec. based on Mkt. Price of those traded Sept. 30, 1929

** Underlying Assets at Mkt., as of Sept. 30, 1929. Total Assets of Affiliated Inv. Co's at Asset Value, Other Sec. at Mkt.

Premium A : Excess of Mkt. Value of Outstanding Sec. of Aff'd Co's in Portfolio over their Asset Value.

Premium B : Excess of Mkt. Value of Outstanding Sec. of Corporation over Mkt. Value of Sec. in Portfolio

Source: Public Examination, Central States Electric Corporation, Respondent's Exhibit No. A.

of Central States at market values were $40,000,000, and were less than sufficient to cover the face amount or par value of its outstanding senior securities.[774] As of June 30, 1938—when the principal investment of Central States still lay in the common stock of The North American Company—the investment company reported assets (consisting of a relatively small amount of cash and securities taken at market values) of but slightly more than $19,700,000 with over $56,000,000 of its own senior securities outstanding, although as of September 1929 its assets at market values were over $350,000,000 and it had senior securities outstanding of $73,233,600.[775] The market appraisal on June 30, 1938 of the outstanding senior securities was, roughly, only one-quarter of their principal or par value, and but 70% of the assets available to meet their claims, as follows:[776]

	Principal amount or par value of outstanding securities	Last market price	Value of outstanding securities at market
Funded debt:			
5% debs., due 1948	$13, 120, 000	34⅞	$4, 575, 600
5½% debs., due 1954	23, 099, 000	34½	7, 969, 155
	36, 219, 000		12, 544, 755
Preferred stock:			
7% pfd	6, 888, 000	14½	997, 600
6% pfd	9, 484, 000	5½	521, 620
Conv. pfd. (of 1928)	1, 531, 300	8	122, 504
Conv. pfd. (of 1929)	3, 166, 100	6⅜	201, 839
	21, 061, 400		1, 843, 563
Common stock	[a] 10, 105, 020		5, 684, 130
			20, 072, 448

[a] Shares.

Furthermore, Central States Electric Corporation had been constructed after 1922 mainly around its acquisition and ownership of the stock of The North American Company, and its interest in this utility company had been frequently utilized as a sales feature in the marketing of securities to the public. Yet by the end of 1938, Central States substantially reduced its direct and indirect interest in The North American Company, until at the close of 1938 its aggregate holdings dropped to but 8.18% of this stock, the reduction having been occasioned apparently by Central States' policy to avoid its coming within the provisions of the Public Utility Holding Company Act of 1935.[777] As of June 30, 1939, Central States owned less than $12,000,000 in assets comprising cash and investments taken at market prices, while it had outstanding $27,479,000 in debentures and more than $21,000,000

[774] Op. cit. supra, note 666, Commission's Exhibit No. 1206.
[775] Id., Commission's Exhibit No. 1237, and Interim Report to Stockholders, June 30, 1938.
[776] Interim Report to Stockholders, June 30, 1938, and *Bank and Quotation Record,* July 1938.
[777] Annual Report to Stockholders, 1938.

in issues of preferred stocks.[778] Thus, if the outstanding debentures had been due June 30, 1939, instead of in 1948 and 1954, respectively, the company would have been insolvent.[779]

V. SPECIFIC INEQUITIES OF MULTIPLE-SECURITY CAPITAL STRUCTURES

The previous sections have treated the advantages which are available to the sponsor, and the disadvantages to which the general investing public is exposed, from the very inception of the multiple-security investment company, by virtue of the innate characteristics of that type of structural set-up. Many sponsors secured to themselves control of investment companies, although they contributed a minimum part of the total investment in these organizations; arranged to obtain for themselves the major share in earnings and profits; and provided themselves with the possibility of a facile and advantageous retirement from the company. The capital set-up, on the other hand, from the very organization of the multiple-security company has disfranchised a large proportion of the investors; has provided inadequate coverage and safeguards for the senior securities; has rendered possible the prospective selling of the investor "down the river"; has inflicted upon the general investors, collectively, exposure to the greater part of losses in operation; has prompted the sponsor to a speculative policy in the management of the company; and has produced, in many instances, so intricate and complicated a structure as to deprive the ordinary investor of an understanding of his rights.

The respective advantages and disadvantages discussed above attach from the formation of the company by the sponsors and flow immediately from the intrinsic character of the multiple-security structure as the latter has manifested itself in the investment company field. In that sense they may be said to be inherent in the common pattern of the multiple-security structure.

Moreover, the existence of two or more classes of securities permits the sponsor, throughout the life of the company, to adopt specific measures and practices which may be favorable to one class of securities and prejudicial to interests of another class of securities or to the company as a whole. It permits the management, frequently, to cause the company to engage in activities which have a discriminatory effect between classes of securities and which tend to favor the shareholdings of the management. For example, a management may distribute to junior securities dividends out of contributed capital or capital gains to the prejudice of senior securities; may utilize the power of "calling" senior securities for redemption in order to shift asset values from the senior security holders to the junior security holders; may embark upon a policy of repurchases of outstanding security issues tending to cause an unnecessary asset loss to one class of security holders and a corresponding gain in assets to another class; may utilize the funds of the investment company to repurchase senior securities at a premium in order to facilitate its own market operations in the common stock;

[778] Interim Report to Stockholders, June 30, 1939.

[779] For a discussion of the payment of interest on these debentures out of capital assets during recent years, see infra, pp. 1807–19.

or may prefer one group of security holders in repurchases of its own securities.

A management may seriously weaken the existing priority of a preferred stock through contracting bank debts which are entitled to a prior lien on assets or, in the absence of adequate safeguards, by the assumption of a bond issue of an affiliated company or by the issuance of bonds or another class of preferred stock with equal or superior privileges. Through the voting power which it may wield, a management can effect exchange programs, consolidations, and mergers through which the senior security holder receives a new security which has less asset value or less protective provisions than that which he surrenders. Managements, or interests associated with them, have depressed the market price of a preferred stock of their own company in order that they might effect private purchases of those securities cheaply and then exercise the power to effect liquidation of the company with a resultant profit equal to the difference between the market price and the asset value of the prefered stock.

The right held by preferred stock to vote or to take over the management upon certain contingencies has been evaded or nullified by practices initiated by existing managements. The most significant right of the senior security holder—the right to receive full payment of the principal or specified sum upon dissolution and liquidation—has in many instances proved illusory because of the dissipation of assets of the company and "unloading" of dubious securities and assets upon the company by the management.

These activities of managements have been more injurious to preference stock and debenture holders than to the common stockholders. The debenture holders have, in addition, been exposed to additional inequities, particularly with respect to the protective features of this type of security.

The succeeding sections will present illustrations of inequities which have resulted from or have been greatly facilitated by capital structures of more than one class of securities.

A. Specific Inequities in Relation to Preference Stocks

1. DISTRIBUTING ASSETS BY WAY OF DIVIDENDS TO THE PREJUDICE OF SENIOR SECURITY HOLDERS

Payment of dividends is a distribution of the assets of the company in which all security holders have a present, future, or contingent interest. In the case of a single-stock company, payment of any dividend results in a uniform distribution of assets to all security holders and whether the payment is out of earnings or out of capital, no discrimination between stockholders exists. Although partial liquidation or a diminution of the working capital may be brought about by the payment of dividends out of capital in the case of a single-stock company also, yet such distributions affect equally all who have a proprietary interest in the company and do not contain any elements of favoritism or discrimination between classes of stockholders.[1]

[1] Distribution of dividends out of capital as a possible wrong against creditors is not considered at this point.

In a multiple-security company, the extent and quality of the rights and claims of the various classes of securities against the assets of the company differ. Hence, the disposition of assets by a company by way of dividends to any class of stock is of vital importance to all the other classes and may readily constitute a serious wrong to other classes of securities which may be entitled under the circumstances to have the assets retained. That the manner in which assets of the company are to be distributed in the form of dividends among the various classes of security holders is all-important is proved by the fact that the charters generally provide that no dividends may be paid to so-called "junior securities" until certain specified dividends have been paid to so-called "senior securities." This "priority" right to dividends alone may be insufficient to protect or safeguard the senior securities, as the company might, in the absence of any other limitation, pay the specified limited dividend on the preferred stock and transfer a substantial part of the remaining assets of the company, in the form of dividends, to the junior classes of stock. State statutes at the present time do not permit an absolutely unhampered freedom in the payment of dividends. However, the corporation laws do generally permit a degree of freedom of action which allows a management to distribute as dividends to junior security holders assets which in all fairness should be retained intact by the company for the protection and safeguarding of the senior securities.

a. Payment of Dividends to Common Stock or a Junior Preferred Stock out of Contributed Capital

The difficulties inherent in the existence of more than one class of stock are illustrated by the not uncommon practice of distributing to junior securities dividends which constitute in fact, although not in form, capital contributed to the company, instead of earnings of the company. The management of the company, which may have a much greater pecuniary interest in the common stock than in the senior securities, may be motivated to distribute dividends to the common stock even though the company has not a surplus over the invested capital from which to distribute them. However, if dividends are paid to the common stockholders out of capital contributions a serious injury would be perpetrated upon the preferred stockholders when the latter are deprived of that margin of safety or "capital cushion" consisting of the fund paid in by the common stock upon the existence of which the preferred stockholders rely in purchasing their stock. Of course, this injury would be more acute if the dividends were paid from capital contributed by preferred stockholders.

The continued existence of the cushion for the preferred stock, which is thus diminished by the payment of common dividends, is of vital importance to the preferred stockholders in at least two respects: (a) As a margin of protection against the impairment through subsequent losses of the capital contributed by the preferred stock itself, and (b) as part of the working capital of the company, in addition to that contributed by the preferred stock which could be

used to increase the corporate earnings available for preferred dividends.[2]

Those distributions of dividends to a junior preferred stock which operate as an impairment of the contributed capital are as prejudicial to the holders of a prior preferred stock as such distributions to the common stock are to every senior security. The "cushion" with which that prior preferred stock has been provided and the working capital which the company is supposed to have at its disposal are diminished.[3]

The corporation laws of many states purport to protect the "capital" of the company from distribution as dividends,[4] but the "capital" which is thus protected is not the entire consideration received by the company for the sale of its securities, but only that part of the consideration received which may have been designated by the management as "capital" in accordance with provisions of state statutes that permit the creation of "stated capital" and "paid-in surplus."[5] The par value stock is often sold at a so-called "premium" or at a price above the par value of the stock and the excess is treated as paid-in surplus.[6] In the case of no par value stock most corporation statutes permit the directors of a corporation, in their discretion, to allocate a portion of the contribution received for such stock to

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[2] In some instances the junior preferred is largely a "management" stock retained, like a substantial part of the common stock, by the sponsoring and controlling interests. See United States & Foreign Securities Corporation, supra, p. 1598–1602.

[3] Graham, Benj., and Dodd, D. L., *Security Analysis* (1934), pp. 224–277. See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part VII, Sec. III.

[4] "The directors of every corporation created under this Chapter, subject to any restrictions contained in its Certificate of Incorporation, shall have power to declare and pay dividends upon the shares of its capital stock either (a) out of its net assets in excess of its capital as computed in accordance with the provisions of Sections 14, 26, 27, and 28 of this Chapter, or (b), in case there shall be no such excess, out of its net profits for the fiscal year then current and/or the preceding fiscal year; provided, however, that if the capital of the corporation computed as aforesaid shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaired" (Delaware Corporation Law, Sec. 34, as amended in 1927).

[5] Thus the Delaware Corporation law authorizes the payment of dividends (1) from net assets in excess of management-allocated "capital" or (2) from the net profits of the current or preceding fiscal year provided that the net assets are not less than the aggregate amount of "capital" allocated by the directors to all classes of securities having a preference upon the distribution of the corporation's assets (Delaware Corporation Law, Sec. 34).

[6] Dewing, A. S., *Financial Policy of Corporations* (3d rev. ed., 1934), pp. 585–8; Montgomery, R. H., *Financial Handbook* (2d ed., 1932), pp. 570–1. The Delaware law provides as follows:

> Any corporation may by resolution of its Board of Directors determine that only a part of the consideration which shall be received by the corporation for any of the shares of its capital stock which it shall issue from time to time shall be capital; provided, however, that, in case any of the shares issued shall be shares having a par value, the amount of the part of such consideration so determined to be capital shall be in excess of the aggregate par value of the shares issued for such consideration having a par value, unless all the shares issued shall be shares having a par value, in which case the amount of the part of such consideration so determined to be capital need be only equal to the aggregate par value of such shares. In each such case the Board of Directors shall specify in dollars the part of such consideration which shall be capital (Delaware Corporation Law, Sec. 14, Del. Rev. Code (1935), c. 65, § 28).

paid-in surplus.[7] In general the directors may declare dividends out of such paid-in surplus.[8] Investment companies in the great majority of cases have been incorporated in states permitting the allocation of a portion of contributed capital to paid-in surplus and the payment of dividends therefrom.[9] Whenever the directors are empowered to designate a part of the capital contributed by the preferred stockholders, as well as that contributed by the common stockholders, as such paid-in surplus, the management is in a position to return to common stockholders as dividends part of the capital invested by them in the company and, should it desire to go so far as to distribute to common stockholders part of the consideration paid into the company by the preferred stockholders.[10] Thus at the very

[7] Weiner, *Amount Available for Dividends Where No-Par Shares Have Been Issued* (1929), 29 Columbia Law Review 906 et seq. See also Note, 31 Columbia Law Review 844; 11 Fletcher, Cyc. Corp., Secs. 5080 and 5125. Some statutes apparently prohibit such allocation (Wisconsin Statutes, S. 182.14, cf. Kansas General Statutes, 1935 § 17–308, –312). Another state law provides that such allocation may be made with respect to the consideration received for common stock but not preferred stock or special stock (Colorado Stat. Anno., 1935, c. 41, § 12). Some statutes merely provide that a corporation may issue no par shares for such consideration as may be determined by the directors and make no provision concerning allocation of such consideration to capital and paid-in surplus (North Carolina, Michie's 1931 Code, § 1167; Oregon Code, 1930, § 25–225, –227; Iowa Code, 1935, § 8419; Kentucky, Carroll's Statutes, Baldwin's Rev., 1936, § 564–2; Texas Rev. Civil Statutes, Art. 1538c). In the latter instances, according to judicial interpretation, the charter may provide for such allocation of proceeds (*Lewis* v. *Oscar C. Wright Co.*, 234 Ky. 814, 29 S. W. (2d) 566 (1930)).

[8] Note, 31 Columbia Law Rev. 844–5; Weiner, op. cit. supra, note 7, at 906 et seq., and Weiner, *Theory of Anglo-American Dividend Law*, 29 Columbia Law Rev., at 471–472. A survey of the state statutes reveals that some 20 state corporation statutes expressly permit the creation of paid-in surplus and payment of dividends therefrom. In other states permission may only be implied. Some state statutes require that the source of such dividends must be disclosed, but no other limitation is expressed (Ohio General Code, § 8623–38; Virginia Code, § 3840, as amended by Session Laws of Virginia, 1932, p. 132; Louisiana Business Corporation Act of 1928, § 26. See Minnesota Business Corporation Act, § 21, permitting dividends only on preferred stock if such stock has been issued). In some states the corporation laws restrict the payment of dividends out of paid-in surplus to dividends on preferred stock (Michigan General Corporation Act, § 22, as amended by P. A., 1935, No. 194; Pennsylvania Business Corporation Law, § 704; California Civil Code, § 346, as amended by Laws 1933, c. 533, § 49; Illinois Business Corporation Act, § 41). Disclosure of the source of these dividends is required (ibid.). Some statutes provide that corporations having no par stock may pay dividends only out of "net profits or surplus earnings" (Missouri Revised Statutes, 1929, § 5107; New Mexico Statutes, Anno., Comp. of 1929, § 32–135; Kansas General Statutes, 1935, § 17–308). It has been suggested that even in these cases dividends may be paid out of paid-in surplus. See Weiner, op. cit. supra, note 7, at 906 et seq., but cf. *American Ref. Co.* v. *Staples*, 260 S. W. 614 (Tex. Civ. App. 1924). The Wisconsin statute apparently prohibits the payment of dividends out of surplus. (See supra, note 7.)

[9] A survey of the states of incorporation of management investment companies known to the Commission to have been in existence at some time in the period from 1927 to 1935 reveals that out of 740 such investment companies 636 were incorporated under the laws of Delaware, New York, Maryland, and Massachusetts. Almost half of the entire number—377 of the companies—had been created under the laws of the State of Delaware. The payment of dividends out of paid-in surplus is permitted in these states (Delaware Corporation Law, §§ 14, 34; New York Stock Corporation Law, §§ 12, 13, 58; Maryland, Bagby's Anno. Code, 1924, and Flack's 1935 Supp., §§ 39, 87; Massachusetts General Laws, 1932, c. 156, §§ 15, 35).

[10] The following hypothetical case illustrates the possibilities under the Delaware statute: The directors of an investment company which has received $5,000,000 for no-par preferred stock entitled to a total of $5,000,000 on liquidation and $1,000,000 for common stock designates the $1,000,000 received for the common stock and $2,500,000 of the $5,000,000 received for the preferred stock as capital and $2,500,000 of the amount received for preferred stock as paid-in surplus. Under the terms of the statute the $2,500,000 is "paid-in surplus" avail-

inception of the multiple securities investment company, the management when it has this power of allocation to paid-in surplus is in a position to expose the actually contributed capital of the company to impairment through the distribution of part of such a paid-in surplus as dividends on the common stock or as dividends on a junior preferred stock.[11]

As a matter of fact, it was a common practice among investment companies to allocate a portion of the proceeds from the sale of capital stock to "capital surplus." Out of 73 investment companies representative of the different types of sponsorship examined for the purpose of obtaining an indication of the prevalence of this practice it was found that 55 had set up a portion of the consideration received for capital stock as "capital surplus." In these instances the par or stated capital value of the stock was fixed at an amount less than the proceeds received from the sale of the stock and the difference used to create such "capital surplus" or "paid-in surplus." While the establishment of such a "surplus" out of contributed capital may have a number of legitimate objectives,[12] its utilization for the distribution of capital assets to junior security holders has been prejudicial to the holders of the senior securities.[13] To use such surplus (created out of part of the stockholders' original contributions) for dividend purposes is to mislead stockholders who think of dividends as distributions of earnings.

The opportunities for the common stock control to visit this type of inequity upon the senior security holders are enlarged by the fact that the creation of this type of capital surplus from which dividends may be paid is not limited to the time of the issuance of the securities. In most states the statutes permit corporations to reduce the "capital" of the corporation by reducing the par value of the shares of any class of stock having par value or by reducing the amount of "capital" represented by shares of stock having no par value.[14] This Commission, in its report on reorganization committees, pointing out the varying circumstances under which the reduction of capital stock can be utilized by corporations in general as a means of distributing true capital assets as dividends, stated:[15]

The injury to preferred stockholders which may result from a reduction of capital stock arises out of the inequities of any distribution which may follow

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able for the payment of dividends to the holders of the common stock. Moreover, if the net assets of the company depreciated to $4,000,000—to a point insufficient to cover the liquidating value of the preferred stock—the company could nonetheless still pay dividends on the common stock because its net assets of $4,000,000 would exceed its statutory "capital" of $3,500,000.

[11] The payment of dividends to the senior preferred stock out of such "paid-in surplus" is also an impairment of contributed capital, but since the senior preferred stock itself is the recipient of the capital assets in the form of dividends, such distribution may not be financially prejudicial. The return of capital in this form may, however, be used to prevent the vesting of contingent voting rights of preferred shares. See infra.

[12] For example, in connection with write-downs and write-offs upon revaluation of assets and losses on investments, particularly when earned surplus is exhausted.

[13] See Marple, Raymond P., *Capital Surplus and Corporate Net Worth,* p. 105.

[14] Del. Corp. Law, Sec. 14. See notes 7 and 8, supra. For a compilation of these statutes and general discussion of the subject see this Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, pp. 483–493.

[15] Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, pp. 483–7.

the reduction. Thus, the reduction of either preferred or common stock in the usual case may react to the ultimate injury of the preferred stockholders by permitting an impairment of the "capital cushion" of the corporation. This "capital cushion" is significant because it measures the extent to which losses from operations or on liquidation are to be borne by the junior stockholders, as distinguished from the preferred stockholders. Although subject to losses, it is the preferred stockholders' expectation that this capital cushion will not be impaired by distributions of assets to junior stockholders. Where the capital cushion is impaired by losses, its existence implies the necessity of replacing the lost values—usually through the retention of earnings—before distributing dividends to junior security holders.

Recently the New York Court of Appeals held that the reduction of the stated capital of the common stock and the transfer of the amount of the reduction to surplus, where it was available for distribution as dividends or for the repurchase of stock, materially altered the preferential rights of the preferred stock. The court stated:[16]

We are thus brought to a consideration of the provision of the amended certificate which reduced the stated capital of the corporation to $2,678,350 and changed the common stock from a no par value stock with a stated value of ten dollars a share to a par value stock with a par value of one dollar a share; the resulting reduction in the stated capital, totaling $1,440,000, being thereby transferred to surplus. Prior to such transfer, the eight-dollar cumulative preferred stock was in a position to benefit from the earning power of such capital, and in the event of liquidation or dissolution such capital would be available for distribution to such stockholders, subject only to diminution by losses in business operations. It could not have been used for dividends or for the purchase of any shares of stock. When this sum of $1,440,000, amounting to about one-third of the capital of the corporation, was transferred from capital to surplus, the eight-dollar cumulative preferred stock lost its right to rely upon this portion of capital. The capital structure was so altered that it was placed within the power of the corporation to deprive forever the preferred stockholders of their preferential rights in regard to this portion of the capital structure. In brief this $1,440,000 was in itself a security of approximately twenty-eight dollars for each share of the old preferred stock and has now by this amendment of the certificate of incorporation become a surplus that may no longer support such stock.

The reduction in capital constitutes a material alteration of the preferential rights of the old preferred for it has reduced materially and finally the amount of stated capital which theretofore had safeguarded the preferential rights of the old preferred stock.

Reduction of legal capital as a means of creating a surplus out of which to pay common dividends and dividends on junior preferred stock has been a more effective instrumentality in the case of the investment company than in other types of corporation because of the great liquidity of the assets of the investment company. While other companies in an unprosperous condition might be faced with the problem of liquidating physical assets in order to obtain funds for the distribution of dividends, the investment company is almost always in possession of the required amount of cash or in the possession of marketable securities readily transformable into cash. But it is not

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[16] *In re Kinney*, 279 N. Y. 423; 18 N. E. (2d) 645, 649 (1939); see comment, 39 Columbia Law Review, 1037–1043.

intended to state that this device is peculiar to investment companies and may not have been used in other types of corporations to the injury of the preferred stockholder.

(1) UNITED STATES & INTERNATIONAL SECURITIES CORPORATION

United States & International Securities Corporation, a closed-end investment company of the unrestricted management type, was incorporated under the laws of Maryland on October 26, 1928, by United States & Foreign Securities Corporation, an investment company, which had been formed and had been controlled by the investment banking firm of Dillon, Read & Co. since October 1926.[17] United States & International Securities Corporation was capitalized with a first preferred stock, a second preferred stock, and common stock. From the inception, the parent company owned 80% of the outstanding common stock and practically all of the second preferred stock. The first preferred stock, on the other hand, was held almost entirely by the general investing public. The capitalization consisted of (a) $50,000,000 invested by the public in 500,000 shares of $5 no par cumulative first preferred stock accompanied by 500,000 shares of common stock, and (b) $10,000,000 invested by the parent company in 100,000 shares of the $5 cumulative no par second preferred stock accompanied by 2,000,000 common shares. The first preferred stock, which was distributed by way of allotment certificates carrying one share of preferred stock and a share of common stock, was sold on the basis of installment payments, 25%, or $12,500,000 payable on the sale, and the rest in installments subject to call by the corporation. The final installment was not called until 1930.[18]

By the end of 1929 the second preferred stock had gone "under water" to the extent of $23.70 per share. By the end of 1930 and thereafter until 1935 there was no asset value whatsoever behind the second preferred stock, while the net asset value behind the first preferred stock was less than the value to which it was entitled in liquidation. Nevertheless, quarterly dividends were paid on the first preferred stock throughout 1930 and on the second preferred stock for the first two quarters of 1930.[19]

The distribution of dividends in 1930, in the case of both the first preferred stock and the second preferred stock, constituted an inroad upon the already impaired contributed capital of the company. On December 31, 1929, the net assets of the company were approximately $4,500,000 less than the amount of net capital contributed to this time.[20]

The first preferred stock, at the inception of the company, had been supplied a cushion of $10,000,000, represented by the consideration paid by the sponsor, United States & Foreign Securities Corporation, for the second preferred stock.[21] This cushion had been reduced by January 1. 1930 by more than 40%. In the face of the existing impairment

[17] Public Examination, United States & Foreign Securities Corporation, at 11772–4.

[18] Reply to the Commission's questionnaire for United States & International Securities Corporation, Pt. V.

[19] Id., Pt. IV, Table 7, and Pt. V, p. 12.

[20] Net assets on Dec. 31, 1929, $33,318,497 (id., Pt. II, Exhibit A). Total paid-in value of outstanding capital stock on Dec. 31, 1929 was $37,964,217 (id., Pt. II, Exhibit A, Schedules 18, 18a, 19).

[21] Op. cit. supra, note 17, at 11774 and 11777.

of invested capital, the management proceeded to declare and pay quarterly dividends on the second preferred stock held exclusively by itself. One quarterly dividend was paid on February 1, 1930, and another on May 1, 1930, the distributions totaling $250,000.[22]

As has already been noted, at the year-end of 1930 the first preferred stock itself was "under water"; the company was not in possession of assets sufficient to pay the first preferred stockholder the $100 per share to which he was entitled in liquidation. Whether such was the situation on February 1 or May 1, 1930, when the dividends were paid out on the second preferred stock, it is impossible to state on the basis of the available data, as the semiannual statements of the company reflect the latter's asset position only on June 30 and December 31. If the first preferred stock was "under water," the management was distributing to the second preferred stock, held by itself, assets belonging to the publicly held first preferred stock. On the other hand, even if the capital contributed by the first preferred stock was still intact on these dates, the distribution of the dividends to the second preferred had the immediate effect of diminishing the very slender existing margin of protection on the first preferred stock and the result of increasing, by the amount of such distribution, the subsequent capital deficit of the first preferred stock.

The company was able to make the dividend payment in 1930 legally unassailable by the use of the technique of allocating only a fraction of the consideration paid for the second preferred stock to "capital" and allocating the remainder to a "Special Reserve." As has been noted above, on December 31, 1929, the net assets of the company were $33,318,497, while the total paid-in value of capital stock was $37,964,-217. There existed no surplus over paid-in capital from which dividends could be paid.[23]

The board of directors had originally stated the "capital" value of the second preferred stock as $99.75 per share.[24] On December 13, 1929, the certificate of incorporation was amended [25] to set aside in

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[22] Op. cit. supra, note 18, Pts. II, IV, and V.

[23] The company showed an earned surplus of $30,950.31 in its statement for December 31, 1929 (issued on January 9, 1930). The statement also showed a capital surplus of $274,-163.56 realized from the repurchase and retirement of preferred stock at less than the amount carried on the books. The combined surplus of $305,113.87 would not have been sufficient to pay the quarterly dividends due on February 1, 1930, on both the first and second preferred stock. Moreover, this surplus disappears and a deficit arises immediately upon giving effect to the unrealized depreciation of $2,676,000 (op. cit. supra, note 18, Pt. II).

[24] Certificate of Incorporation, Paragraph "Eighth" (op. cit. supra, note 18, Pt. I, Ex. A–12, and annual report for 1929).

[25] The articles were amended to provide:

> By reducing the issued amount (or stated value) of the capital stock of the Corporation by the sum of $9,475,000, through the reduction of the issued amount (or stated value) of the second preferred stock of the Corporation from $9,975,000 to $500,000, without changing the number of issued shares, the entire amount of such reduction to be credited on the books of the Corporation to a Special Reserve to be used and dealt with from time to time in the discretion of the Board of Directors in accordance with and subject to the following provisions:
>
> Such Special Reserve may be charged with or used to offset the amount of any loss of any nature incurred through any transaction of the Corporation or any diminution in the value of any asset of the Corporation, and may be used for the payment of dividends upon the first preferred stock in amounts which, together with the amount of dividends theretofore paid thereon, do not exceed a total of five dollars ($5.00) per share per annum from the date after which dividends thereon became cumulative. No part of such Special Reserve shall be used in any manner for the payment of dividends on any class of stock junior to the first preferred stock, or, except on the liquidation, dissolution, or winding up of the Corporation, be used for any distribution on any class of stock junior to the first preferred stock, and then only subject to the pref-

effect a large part of its capital assets for the payment of dividends. Ernest B. Tracy, president of United States & International Securities Corporation, testified that the company had paid dividends out of capital surplus and had set up its junior money at $5 per share as capital and $95 per share (more than $9,000,000) as a reserve out of which dividends could be paid.[26]

While the amendment, it will be noted, specifically recited that the "Special Reserve" should not be used for paying dividends on the Second Preferred Stock, the creation of a source out of which dividends on the first preferred stock might be paid left the earned surplus account free to be used for the payment of dividends on the second preferred stock. As a matter of fact, the 1930 dividends on the second preferred stock were charged to "earned surplus." While the holders of the first preferred stock might have been aware that a part of the company's capital assets was being segregated for use as prospective dividends to themselves, the question is posed whether they realized that other assets of the company were thus being made available for the distribution of dividends to the junior stockholder. The dividend on second preferred stock paid on May 1930 was the last dividend payment on the second preferred distributed by the company. In the statement of June 30, 1930, the company announced that a dividend of $1.25 a share on the first preferred stock had been declared and would be paid on August 1, 1930. No dividend was declared at that time on the second preferred stock. The condensed balance sheet for June 30, 1930, showed a balance in the earned surplus account at that date of over $1,000,000.[27] Had the company so desired, it could have continued to pay dividends to the second preferred stock from "earned surplus," whose existence was perpetuated by the use of the "capital surplus" (general reserve) for the payment of dividends to the first preferred stock. However, the company ceased paying dividends to the second preferred stock at this time—ceased making distribution of dividends to junior security holders out of contributed capital—even though permissible under the provisions of state laws.

(2) AMERICAN CAPITAL CORPORATION[28]

American Capital Corporation, a closed-end management investment company, which was organized under the laws of Delaware on May 19, 1928,[29] by a group of Los Angeles businessmen with the assistance of Jonathan B. Lovelace, partner of E. E. MacCrone & Co., a Detroit brokerage and underwriting firm,[30] was closely related to

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erences of any class or classes of stock having priority to such junior class of stock. Such Special Reserve may be reduced by crediting all or any part thereof to capital. If such Special Reserve shall have been reduced as aforesaid otherwise than by such a credit to capital, an amount equal to such reduction shall be credited to such Special Reserve before any dividend shall be paid by the Corporation upon any class of stock junior to the first preferred stock. In determining amounts available for the payment of dividends on any class of stock junior to the first preferred stock, no part of such Special Reserve shall be used to offset as aforesaid any loss or diminution in value (id., Pt. I, Exhibit A–2, p. 14).

[26] Op. cit. supra, note 17, at 11759.

[27] Op. cit. supra, note 18, Pt. I, statement for June 30, 1930.

[28] See capital structure chart for this company, Appendix I, p. 1939.

[29] Reply to the Commission's questionnaire for American Capital Corporation, Pt. I, Item I.

[30] Public Examination, American Capital Group, at 7094, 7105.

other investment companies, the whole group being known as the American Capital group.

The certificate of incorporation of American Capital Corporation authorized the issuance of four classes of stock: prior preferred stock, preferred stock, Class A common stock, and Class B common stock.[31] The prior preferred stock, with a right on liquidation to $100 per share, was entitled to prior cumulative dividends of $5.50 per annum.[32] This class of stock had no voting rights, except in the event of default in dividends. Upon one year's default, the prior preferred stock acquired a voting participation with the regular voting stock; if the default continued for two years, the prior preferred stock as a class received exclusive voting power. The preferred stock, with a liquidating right of $50, was entitled to cumulative dividends of $3.00 per annum and contingent voting rights similar but subject to those of the prior preferred stock. The Class A common stock and Class B common stock had sole regular voting rights equally subject to the contingent voting rights of the preferred issues. The Class A stock was entitled to $32 upon liquidation, and the Class B stock to $10; thereafter these classes of stock shared equally in any surplus.[33]

At inception, the organizers of the investment company (constituting the first board of directors) agreed to purchase 210,000 shares of Class B common stock at $2 a share.[34] They also agreed to place with the public 33,333 units, each of which consisted of three shares of Class A common stock and two shares of Class B common stock at $100 a unit.[35] The preferred issues were underwritten by Bonbright & Company, Inc., of New York City. That underwriting house made a firm commitment for 60,000 shares of prior preferred stock and 120,000 shares of preferred stock. Each share of the preferred issues was accompanied by a bonus of one-half share of Class B common stock.[36]

By June 1928 the company had received total net proceeds of $15,153,300 from the sale of its securities (gross proceeds $15,753,-300).[37] The net capital contributed by each of the four issues of stock was as follows:

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[31] Reply to the Commission's questionnaire for American Capital Corporation, Pt. I, Exhibits A and B.

[32] Id., Pt. V, Item 35.

[33] Ibid. The dividend arrangement for these classes of common stock provided that noncumulative dividends of $2.00 per annum be paid to the Class A stock before any dividends were to be paid to Class B stock. Thereafter each share of Class B stock received twice the amount declared upon the Class A stock until both classes received $4.00. Dividends thereafter were shared in equally by both classes.

[34] Reply to the Commission's questionnaire for American Capital Corporation, Pt. I, Exhibit D.

[35] Ibid. In consideration of this undertaking, the directors received 325,000 warrants to purchase Class B common stock at $10 a share before June 30, 1940 (ibid.).

[36] Id., Exhibit E. Bonbright & Company, Inc., received 15,000 warrants to purchase Class B common stock in addition to its commissions (ibid.).

[37] Subsequently, the investment company issued additional shares of common stock. From July to December 1930, 10,743 units of Class A and Class B common stock sold to the public at $31 a unit, netted the company $324,663. From September 1930 to April 1931 as the result of an exchange of American Capital Corporation 255,523 shares of Class B common stock for Class B common stock of Pacific Investing Corporation, an additional contribution to the capital of American Capital Corporation was obtained valued at $255,523. The total net contributed capital of the company, therefore, came to $15,733,486 (Public Examination, American Capital Group, at 7098).

	Amount outstanding at June 2, 1928 (shares)	Price [a]	Net proceeds
$5.50 prior preferred stock	60,000	$95.50	$5,730,000
$3.00 preferred stock	120,000	46.50	5,580,000
Class A common stock	99,999	32.67	3,266,634
Class B common stock:			
Issued with prior preferred	30,000	1.00	30,000
Issued with preferred	60,000	1.00	60,000
Issued with Class A stock	66,666	1.00	66,666
Issued to organizers	210,000	2.00	420,000
			15,153,300

[a] For securities sold in units, prices are based on amounts taken into capital accounts.

The entire amount that the sponsors apparently invested in the company was $420,000 (or 2.7% of the gross contributed capital) for approximately 54.5% of the outstanding Class B common stock. All of the prior preferred stock, preferred stock, and Class A common stock was distributed to the public.[38]

The company was successful only in its first year of operation. By the end of 1929 the net contributed capital was impaired to the extent of $102,492. The impairment amounted to approximately $4,000,000 by December 31, 1930, the net assets of the investment company having shunk to $11,025,681 at that time.[39] Nevertheless, dividends were paid during 1929 and 1930 to holders of both classes of preferred stock and to holders of Class A common stock. Whether the distribution of dividends to Class A common stockholders during 1929, amounting to $199,422, was made at a time when the company's contributed capital was impaired is not certain. The dividends may have been declared prior to the fall in the market value of portfolio securities. However, in any event the distribution of $750,396 in dividends in the succeeding year coincided with a most serious existing and progressively increasing impairment of contributed capital. Of the dividends, totaling $750,396, paid out during 1930, the sum of $99,999 was paid to the holders of Class A common stock.[40] The "cushion" of assets that had been supplied both classes of preferred stock at the inception of the company, and which had been seriously reduced as a result of market depreciation, was thus further diminished by the payment of dividends to common stockholders. Thus the Class A common stock received dividends at a time when the "cushion" for the preferred stocks, supplied at inception by the capital contributed by the common stock, had been almost entirely eliminated. At the end of 1930 the asset coverage of the junior preferred stock, entitled to $50.00 upon liquidation, was $51.00 per share. By the end of 1931 the preferred stock was "under water" to the extent of $36.11 and remained "under water" until the end of 1935. Instead of maintaining

[38] See Appendix, p. 1939.

[39] Op. cit. supra, note 29, Pt. II, Exhibit A. Net contributed capital amounted to $15,019,612 making allowance for repurchases of shares of the preferred issues (id., Exhibit A and Schedule 18, Parts I and II).

[40] Id., Pt. II, Schedule 20–A.

the capital cushion intact for the preferred security holder in the face of a downward trend of security values, the management had distributed during 1930 part of the assets of the company to common-stock holders.

In 1929 and 1930 dividends to stockholders were paid out of the "earned surplus account." This "earned surplus" was an account to which had been credited not only the net ordinary income but also capital gains realized from the sale of portfolio securities. Realized losses on the sale of portfolio securities in 1930 were charged against the "earned surplus account." In 1931 realized losses from the sale of portfolio securities completely eradicated earned surplus and even made a slight inroad upon the capital surplus account, which consisted of that part of the capital contributed by the common stockholders, which the management had stated as "surplus." [41]

Capital contributed by both the common stock and a junior preferred stock serves as a "cushion" for a senior or prior preferred stock. Hence the payment of dividends to a junior preferred out of contributed capital effects a diminution of the "cushion" of a senior or prior preferred stock. By the end of 1931 the net assets of the investment company totaled no more than $4,453,130. The asset value of the preferred stock (junior) was $36.00 per share below its stated liquidation value ($50.00 per share); nevertheless during 1931 full dividends amounting to $232,612 were paid to the junior preferred stock. The prior preferred stock, which had suffered the elimination completely of the "cushion" provided by the common stock capital of a substantial part of the "cushion" which had been provided by the junior preferred capital, was thus subjected to another drain upon its "cushion" by the payment of dividends to the junior preferred stock.

As there was no "earned surplus" during 1931, dividends were, during that year and the succeeding year, paid out of capital surplus. In 1931 the stated value of preferred stock was reduced to $10.00 per share, and the difference between that value and the original value was credited to the capital surplus account increasing that item to $7,614,147 on the books of the company.[42] In 1932 the investment company continued the practice commenced the previous year, of repurchasing the preferred issues from the public at prices below asset value. Almost one-half of the entire outstanding issue of prior preferred stock was repurchased in this year at a book profit of $661,933, which was credited to the capital surplus account. Thus, the dividends which were paid to the junior and senior preferred stock-

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[41] The capital surplus account created after the issuance of the securities of the investment company was credited with $3,346,635, leaving $11,686,665 as book capital. The capital surplus account consisted of $3,166,635 of the $3,333,300 derived from the sale of the units of common stock to the public, $90,000 allocated to the Class B common stock sold with the preferred issues, and $90,000 from the proceeds of the sale of Class B common stock to directors for $420,000 (id., Pt. II, Exhibit A, Schedule 18 (Parts I and II) and Schedule 19).

Pursuant to its underwriting agreement with the directors of the investment company, the company placed $120,000 of the $420,000 contributed by them in a reserve account to be applied to organization expenses and costs of operation for the first two years of the company's existence (id., Pt. I, Exhibit D).

[42] The difference between the original value and the new stated value credited to capital surplus amounted to $3,744,000 (id., Pt. II, Schedule 20–A). Other credits were profits from the repurchase of the preferred issues by the company (ibid.).

holders were composed primarily of capital contributed by the junior preferred stockholders but now designated "surplus," and of profits made by the company through the retirement of senior security holders at a loss in asset value to them.

In 1932, the value of the assets of American Capital Corporation amounted to only $3,656,713, and even the prior preferred stock was only paid a partial dividend. Realized losses from the sale of portfolio securities amounted to almost $4,000,000. The capital surplus account,[43] which was charged with these losses, amounted to $4,108,766. Had it not been for the reduction in stated value, and repurchases of the preferred stock not only would there have been no capital surplus but there would have been an actual impairment of capital, barring the payment of any dividends.[44]

Jonathan B. Lovelace, a director of American Capital Corporation, and one of its co-organizers, when examined on the reason for the reduction of the stated value of the stock of the company, testified:[45]

Q. That happened in 1930, or in 1931, when the balance of $65,000 was transferred out of the earned surplus into the capital surplus. Incidentally, it was in the same year when about $3,000,000 of capital surplus was created on reducing the stated value of the stock.

A. That was probably part of that program.

Q. What was the idea then of their program of switching accounts and transferring items from one to another and creating a surplus by reducing the stated value of capital stock? Do you recall the circumstances?

A. No. If it was 1930 I was probably not very familiar with it. I thought I was familiar with the accounting phases of all of these companies. But I can see the point you are making. I think you are entirely correct in it.

* * * * * * *

A. The purpose there was this: Under the Delaware law you can pay a dividend so long as your assets exceed your stated capital of your preference stock. Unless you have current earnings you cannot do it. If it does not exceed the stated capital of your preference and common stocks. So we wrote down the common stock so as to be able to maintain dividends on the preferred.

The payment of dividends to the preferred stock out of contributed capital may have been prompted, in part, by the fact that sustained dividend defaults would have taken the control of the company out of the hands of the existing management[46] and vested the same in the preferred stockholders.

In 1933 current and accrued dividends were paid to the prior preferred stockholders, and a one-fourth dividend was paid to the preferred stockholders. Since the preferred stock was "under water" at the beginning of that year and had an asset value of only $17.00 at the end of the year, this distribution to the preferred stock was

[43] In this year Class A and Class B common stock was reduced in stated value to 10 cents, enabling the transfer of $858,015 to the capital surplus account to take place.

[44] Repurchases of preferred stocks and reduction in stated value of the preferred stock accounted for the transfer to capital surplus of $4,968,182. Thus, had these repurchases and reduction in stated value not taken place, there would have been an impairment of stated capital to the extent of about $900,000. Ordinary income of $118,514 and losses from the sale of portfolio securities of $3,915,934 resulted in a deficit of net income amounting to $3,797,420 in this year (op. cit. supra, note 29, Pt. II, Schedule 20).

[45] Public Examination, American Capital Corporation, at 7420–1.

[46] Op. cit. supra, note 29, Pt. V, Table 15–A.

apparent made at a time when the capital paid in by the preferred stock was impaired.[47]

Moreover, the total amount of dividends paid exceeded ordinary income by approximately $300,000.[48] Profits from the sale of portfolio securities were credited to earned surplus instead of to capital surplus in recoupment of the huge losses from the sale of portfolio securities that had previously been charged to capital surplus. Through this inconsistent accounting procedure the directors were enabled to pay dividends out of earned surplus to preferred stockholders as well as to holders of prior preferred stock.

The situation at the end of 1934 was similar to that of 1933, except that a full dividend had been paid to the preferred stock during that year, which had had the effect of staving off the transfer of exclusive voting power to that stock.[49] Dividends aggregating $450,701 were paid that year out of contributed capital.[50] Net ordinary income only came to $89,407 but profits from the sale of portfolio securities credited to earned surplus brought that account to an amount greater than the amount of dividends paid.

The 1935 ordinary income was still insufficient to cover the dividends to the prior preferred stock although the repurchase program reduced the total amount of outstanding preferred stock to 25,261 shares by the end of that year.[51] In fact, only a partial dividend was paid to the holders of the preferred stock in 1935 resulting in the accumulation of more than two years of dividend arrearages of that stock. Hence, the continuous distribution to the junior preferred stockholders, from 1930 to 1935, of more than $1,000,000 in dividends, out of contributed capital,[52] failed to avert the vesting of the contingent management control in the hands of the preferred stock.

Pursuant to the provisions of the charter of American Capital Corporation exclusive voting rights as a class passed to the preferred stock.[53] A meeting of this class of shareholders of the investment company was called for April 27, 1936, for the purpose of assuming the management. However, by this time one of the other investment companies in the American Capital group, Pacific Southern Investors, Inc., managed by practically the same directors as American Capital Corporation, had acquired 20,637 shares of the 102,450 outstanding shares of preferred stock, enough to constitute working control under the new phase. Hence, no actual displacement of the existing management occurred.[54]

[47] Id., Pt. II, Exhibit A.

[48] Total dividends amounted to $337,673. Ordinary income amounted to $38,670 (id., Pt. II, Schedules 20 and 20–A).

[49] Id., Pt. II, Schedule 20–A.

[50] Net assets at market were $4,636,335 and net contributed capital was $12,959,975 at December 31, 1934 (id., Pt. II, Exhibit A, and Schedules 18 and 19).

[51] Net ordinary income amounted to $74,751; securities sales profits amounted to $573,787; dividends totaled $292,646 (id., Pt. II, Schedules 20 and 20–A).

[52] From 1930 to 1935 $1,123,049 was paid in dividends to preferred stockholders. Most of these payments were made at a time when the assets of the company at market value were insufficient to cover the paid-in capital, as well as liquidating value of the junior preferred stock and, hence, these payments to the preferred stock may be said to have been made out of the preferred stock (id., Pt. II, Schedules 20 and 20–A).

[53] Id., Pt. I, Exhibits A and B.

[54] For a detailed discussion of this phase, see infra, pp. 1798–1800.

b. Payment of Dividends to Common Stock or Junior Preferred Stock out of Capital Gains

The payment of dividends on junior securities out of profits on portfolio security transactions ("capital gains") in a period of rising market prices, has in many instances resulted in injury to the senior securities with the advent of a period of less favorable market conditions. If capital gains are distributed in the form of large dividends to junior securities, subsequent capital losses may have to be borne by the senior security holders. In Great Britain and Australia dividends are distributed only from ordinary current income (interest and dividends on portfolio securities), and profits from the sale of securities ("capital gains") are retained as a reserve against possible subsequent "capital losses."

In the period before October 1929, when trading results were generally favorable, profits from the purchase and sale of security investments were usually classed as "income" without distinguishing such capital gains from current income. In 1931 the New York Stock Exchange stated that:

> The Committee favors the elimination from the Income Account of all profits and losses on security transactions and crediting and debiting them, preferably to a properly designated reserve, or else to a special surplus account which would be a segregated part of the Earned Surplus.[55]

A statement in that year by the New York Stock Exchange on investment trusts pointed out that the segregation of current income from security profits was of particular significance to senior securities and that such segregation would eliminate any basis for the illusion that occasional profits realized on the sale of securities constitute a continuing increased earning power.[56]

Don C. Wheaton [57] and Louis H. Seagrave of the United Founders Corporation group of investment companies, testified that these companies, in their annual reports from 1926 to November 1929, failed to segregate profits from the sale of investments from the other earnings. Mr. Seagrave testified that he would not now follow this practice.[58]

> Q. You will observe that in the annual report there is some discussion of the earnings of the Trust, but there is no reference in this discussion to the fact that the income and profits are all lumped together in the figure of $2,829,000?
>
> A. That is right.
>
> Q. And of that figure, as appears from Exhibit 3466, the report of Messrs. Clarke, Oakes & Greenwood, $2,084,000 represents profits from trading in securities.

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[55] Special requirements adopted by New York Stock Exchange in 1931.

[56] Statement on Investment Trusts by the New York Stock Exchange, 1931:

> Such gains and losses are more closely related to the unrealized appreciation or depreciation of the portfolio than to the current dividend and interest income. If this procedure is followed, investment trust reports will be more informative to investors, in that the income account will then clearly set forth merely the net result as between current income and current outgo, and this information, separated from security profits, is of particular value to holders of prior securities bearing a fixed rate of return. Furthermore, there would thus be eliminated any basis for the illusion that occasional profits realized on the sale of securities form a proper basis for increasing continuing earning power.

[57] Public Examination, American General Corporation, et al., at 23124–3.

[58] Id., at 22910–3.

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A. That comes from the statement of income in the report certified by Clarke, Oakes & Greenwood.

Q. Does not it seem to you, Mr. Seagrave, that where you are discussing earnings, devoting a whole half page to the discussion of earnings, that it might have been well to have taken your stockholders into your confidence and to have pointed out that five-sevenths of the income was profit from trading in securities and that of that five-sevenths, or $2,000,000, $1,033,000 came from the sale of option shares and from the sale of Class B shares, $148,000 came from the profit in trading in its own shares and only $900,000 came from the trading in securities in the general portfolio? Don't you think it would have given quite an accurate picture to your stockholders?

A. You have pointed out a number of times here that that is what we did at that time. It seemed all right at the time. Today I would certainly break up these income statements.

Dr. Leland R. Robinson, author of books on investment trusts written during the period from 1923 through 1929, who occupied a very influential position in the management of the Founders companies,[59] testified that he did not move the companies in the United Founders Corporation group to compliance with the principle of segregation of security profits from current income which he strongly advocated in his books:[60]

Q. * * * In your book you have made it perfectly clear that in England the investment profits were not treated the same as income. You knew that and you knew it was a conservative practice, rather more conservative than the American practice, but you pointed out that profits must be treated separately from other income.

A. That they should be.

Q. That they should be. You also gave a form of income statement in your book which shows profits treated separately from other income.

A. Yes, sir.

Q. And that was based upon financial grounds so well known we need not pass on them?

A. Yes, sir.

Q. But when it came to giving a report of Second International, you didn't do that?

A. Not prior to 1929.

Q. Why was that? Your accountants did make the separation for you? Why didn't you in your report separate it?

A. We should have done so. There was considerable disagreement among us as to whether we should do it or not.

* * * * * * *

Q. * * * there is nothing in the tax law that profits shall be set in the same heading with your income?

A. Certainly not. The big issue there, much bigger than anything else is that properly speaking profits have no part in income. We will never have sound investment accounting until they are excluded from income altogether. May I finish that comment by pointing out that there was a time when the Scottish Revenue Authorities treated the issue in Scotland as our Government does now, but when the Revenue Authorities of Scotland and England, which has been true now for many years, applied uniformly this distinction

[59] Id., at 24939–44 and Commission's Exhibit No. 3951.
[60] Id., at 24997–25001.

between finance companies and investment companies, never to pay dividends out of profits, then the accounting system became uniform and I hope we will move toward this in this country. We are bound for ruin if we do not.

* * * * * * *

Q. You stated your conviction was unequivocal and uncompromising in prior hearings, but you never really actually voted in favor of that on the books of Second International?

A. In favor of what?

Q. Segregation.

A. The thing never came to a formal vote. I think if I had pushed as much for it as now in retrospect I wish I should have, it would. We discussed it in the meetings and we would, one or two of us take a strong position against it, and some in favor of it, and we finally came to that degree of segregation even antiquated in 1929, and from that time forward did segregate.

Q. And the statements or files showing a commingling of the two does allow a plain avenue open to misrepresentation by salesmen?

A. Obviously any earning statement which includes any profits, whether segregated or not is misleading because profits in the very nature of the case are not recurrent. The question is whether they are ever included in income. They have no right to be there. I stood for their being included in income for a number of years and the reason why I honestly believed at that time that we had an organization at 50 Pine Street that would make the Scottish organization sit up and take notice and I remember how thrilled I was when one of the oldest and best known investment men in Scotland came over and how amazed he was. We all thought we were going to make our 8, 10, and 12 percent a year. We felt even if it cost us twice as much as it cost the British it was all right, but we were wrong.

Dr. Robinson conceded that a considerable part of the dividends to the common stockholders of the Founders companies was paid out of the profits from the sales of portfolio securities.[61]

May I call your attention to this fact: You will find that, in the reports of those companies as a rule, in the text of our reports we point out the extent to which the income from dividends and interest cover the totals. We point out in several of our reports, I just happened to notice a few minutes ago before I testified our normal incomes were sufficient, we met all interest and deferred dividends. It is true a considerable part of common dividends were met out of profits.

Christie P. Hamilton, president of Illuminating and Power Securities Corporation and of American European Securities Company,[62] strongly urged at the public examinations that profits made by the sale of investments should not be available for the payment

[61] Id., at 25001. Dr. Robinson urged that investment companies should not be permitted to pay cash dividends out of profits on portfolio transactions.

Investment trusts should be required to exclude all capital profits and losses from earnings and to run them through surplus statements. This means that all profits resulting from turn-over of securities should be set aside in the form of reserves against which losses may be charged. It further means that no cash dividends should be paid out of such profits and that all of the ordinary running expenses of the company should be met out of interest and dividend income (Id., Commission's Exhibit No. X4338).

[62] Public Examination, Illuminating and Power Securities Corporation, at 9224 and 9230.

of dividends, but should be set up in a reserve account and held against the possibility of future losses on investments:[63]

> Increases in market value should not be considered earnings and, in my opinion, are no basis to be used in paying dividends, nor do I feel that a retirement of capital, thereby creating a so-called surplus, is a basis to be used in paying cash dividends. A good practice—if gains are secured by corporations or "trusts" through the sale of investments—would be to put such gains into a reserve account and hold against the possibility of future losses on investments.

The distribution of cash dividends to common stockholdings out of transient capital gains has been as characteristic of small investment companies as of the larger ones.

Fairfield Securities Corporation (formerly Jackson & Curtis Securities Corporation) illustrates the injurious effect of this practice of paying dividends out of capital gains upon senior securities when a rising market is succeeded by a market recession.

(1) JACKSON & CURTIS SECURITIES CORPORATION, SUBSEQUENTLY KNOWN AS FAIRFIELD SECURITIES CORPORATION

Jackson & Curtis Securities Corporation (the predecessor in name of Fairfield Securities Corporation) was organized on May 31, 1924, as a general management investment company by the brokerage and underwriting firm of Jackson & Curtis.[64] The name of the company was changed to Fairfield Securities Corporation on February 9, 1937.[65] As of December 31, 1927, the contributed capital consisted of $1,250,000: $750,000 for preferred stock distributed to the public; $250,000 for the Class A common stock; and $250,000 for the Class B common stock.[66] Up to January 1932, the preferred stock was a $100 par value, 6% cumulative stock.[67] Throughout the history of the company the two classes of common stock had equal rights in the distribution of dividends and assets on liquidation, but voting rights were vested solely in the Class B common stock.[68] Both classes of common stock were held principally, and after 1928 exclusively, by Jackson & Curtis, the sponsor.[69]

In 1927, 1928, and up to the stock market collapse in 1929, the company realized substantial capital gains from the sale of portfolio securities—$106,796.33, $183,281.13, and $368,539.95, for the respective years. The net ordinary income (before the payment of taxes) during these years was, however, much less—$56,476.75, $36,866.70, and $14,518.32, respectively.[70]

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[63] Id., at 9287.

[64] Reply to the Commission's questionnaire for Fairfield Securities Corporation, Pt. I, Items 1 and 5.

[65] Derived from supplementary information supplied the Commission by Fairfield Securities Corporation.

[66] Op. cit. supra, note 64, Pt. V (Schedules 18, 19, 19a) and Pt. V, Item 42.

[67] Id., Pt. V, Item 35a.

[68] Id., Pt. V, Item 51.

[69] Id., Pt. II (Schedules 18, 19, 19a) and Pt. V, Item 42.

[70] Id., Pt. II (Schedule 20a).

Practically all the current income was required to pay the regular dividends on the preferred stock, amounting to $45,000 per year. A much larger aggregate sum, $311,845, was declared and paid to the common stock as cash dividends out of the capital gains. In addition, the Class A common stock, which had been acquired in 1928 at cost of $221,521.04, was distributed to common stockholders as a dividend and charged to capital surplus arising from write-up of portfolio securities from cost to market value.

The following figures illustrate the relationship between ordinary income, capital gains, and dividends to common stock in the period 1927 through 1929.[71]

	1927	1928	1929
Net ordinary income (before taxes)	$56,476.75	$36,866.70	$14,518.32
Realized capital gains	106,796.33	183,281.13	368,539.95
Net profit	152,378.76	194,089.54	348,337.32
Dividends paid:			
Preferred (cash)	45,000.00	45,000.00	45,000.00
Common (cash)	25,000.00	70,000.00	216,845.00
Common treasury stock common A (cost)			221,521.04
Total dividends	70,000.00	115,000.00	483,366.04

In 1931, the company's net worth, with securities computed at market, had fallen below the amount of contributed capital.[72] In 1930, the company had suffered actual realized losses on the sale of securities of $188,798.94 and in 1931 of $99,693.27 and on December 31, 1931, the portfolio securities which the company still held had so fallen in market value that the net assets of the company, securities at market, were but $547,598.[73] The net assets of the company were about $140,000 or 20% short of meeting the principal amount of $100 par value preferred stock.[74] If the capital profits which had been distributed as dividends to the common stock, in 1929 alone, had been retained as a reserve against such capital losses as actually occurred, the preferred stock would have been completely covered. Instead, the preferred stock continued to be "under water" until the end of 1934.[75]

A considerable proportion of the preferred stockholders took their losses in the years from 1930 to 1935. During this period the company repurchased 2,072 of the total of 7,500 shares of preferred stock

[71] Id., Pt. II (Schedules 17b, 20a) and Pt. V, Item 39.

[72] Id., Pt. II, Exhibit A. The net worth was also below book capital.

[73] Id., Pt. II, Exhibit A.

[74] Ibid. At the end of 1931, there were 6,858 preferred shares outstanding. Net assets of $685,800 were required to meet obligations to outstanding preferred shares. Thus, there was a shortage of $138,202 (approximately $20 per share) in net assets (17% of principal amount of the outstanding preferred obligation).

[75] Ibid.

outstanding at an average cost to the company of $58.89 per share,[76] or $41.19 less than par. The repurchase prices were also below the then net asset values.

Had the capital gains of 1927, 1928, 1929 been retained as a reserve, the asset value of the preferred stock might not have fallen below the $100 par value during the subsequent period.

On January 28, 1932, the stated capital of the company was reduced 90% to $125,000 by changing the $100 par value 6% preferred stock into a $6.00 cumulative no par preferred stock. This enabled the company to continue the payment of dividends, at a reduced rate, to the preferred stock from that date through 1935.[77]

c. Circumvention of the Limitation Upon Creation of "Paid-In Surplus" Out of Capital Contributed for Par Value Preferred Stock

The State of Delaware and most other States restrict the creation of "Paid-In Surplus" in the case of stock having a par value to that part of the consideration received for the stock which is in excess of the par value.[78] Hence, when a preferred stock (or a common stock) has been given a par value and no premium above that par value has been received by the company on the sale of that stock, the management is compelled to allocate the entire par value to "capital" and is unable to establish a "paid-in" surplus available for the distribution of dividends.

(1) THE EQUITY CORPORATION—INTERSTATE EQUITIES CORPORATION

This was the situation in Interstate Equities Corporation, an investment company organized in Delaware, the preferred stock of which company had a par value of $50 per share.[79] No part of the $50 capital contributed by preferred stockholders for their stock could be allocated to "paid-in" surplus.

[76] See the following table:

Year	Number of shares	Net asset value per share		Cost per share	Total cost	Reduction from issuance price
		End of year	Average of (beginning and end of year)			
1930	25	$100.00	$100.00	$93.00	$2,325.00	$175.00
1931	617	79.85	89.92	87.29	53,857.25	7,842.75
1932	846	60.26	70.06	40.69	34,423.00	50,177.00
1933	293	74.76	67.51	43.44	12,728.00	16,572.00
1934	200	97.08	85.92	59.02	11,804.75	8,195.25
1935	91	100.00	98.54	75.53	6,873.00	2,227.00
Total	2,072	----------	----------	58.89	122,011.00	85,189.00

[77] Op. cit. supra, note 64, Pt. IV (Item 28) and Pt. V, Table 16.

[78] Delaware General Corporation Law, Sec. 14; see also supra, this chapter, pp. 1710–22.

[79] Public Examination, The Equity Corporation, Commission's Exhibit No. 831.

The Equity Corporation, another investment company, from the time of its formation,[80] had the control of Interstate Equities Corporation through the ownership of its common stock. Approximately 98% of the preferred stock of Interstate Equities Corporation was held by the public.[81] The fact that this preferred stock carried a par value of $50 gave the holders thereof at least the measure of protection that part of his invested capital could not by a mere resolution of the directors be converted into a paid-in surplus and disbursed in the payment of dividends.[82]

The preferred stock could be changed from a par to a no-par stock of its par value reduced under the Delaware law only with the formal consent of a majority of the class of stock affected—the preferred stock.

The Equity Corporation, commencing in June 1933, proceeded to induce the holders of the Interstate Equities Corporation convertible preferred stock to exchange that stock for the convertible preferred stock of The Equity Corporation which had been issued for the purpose of the exchange.[83] The Equity Corporation preferred, although entitled to $50 per share on liquidation of the company and carrying a $3 dividend rate like the Interstate Equities Corporation preferred stock had a par value of only $1 per share.[84] Each share of Interstate preferred stock received by The Equity Corporation in exchange for Equity's preferred shares was evaluated at $50, the amount to which each share of Interstate preferred stock was entitled on liquidation.[85] Since the par value of the Equity preferred stock was but $1 per share, The Equity Corporation was in a position under the Delaware law to allocate $1 per share of its own preferred stock to "capital" and $49 per each share to "paid-in surplus." This practice The Equity Corporation followed with the $1 par preferred stock which it issued in exchange not only for the preferred stock of Interstate Equities Corporation but for the preferred stocks of the other investment companies embraced within The Equity Corporation exchange program.[86] The following resolution of the Board of Directors is representative:[87]

Resolved, That of the consideration received by the corporation for the issue of each said shares of its Preferred Stock of the par value of $1.00 per share, $1.00 be allocated to capital and $49.00 per share be allocated to surplus, and that of the consideration received by the corporation for the issue of each of said shares of its common stock of the par value of 10¢ per share, 10¢ per share be allocated to capital and 90¢ per share be allocated to surplus.

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[80] The Equity Corporation held the majority of voting stock of Yosemite Holding Corporation, which had voting control of Chain & General Equities Corporation, which in turn held voting control of Interstate Equities Corporation (ibid.).

[81] Id., at 11990–1.

[82] Delaware Revised Code (1935) C65, Sec. 14.

[83] Public Examination. The Equity Corporation, Commission's Exhibits Nos. 839 and 840.

[84] Id., Commission's Exhibits Nos. 831 and 1173.

[85] Id., Commission's Exhibit No. 777.

[86] Ibid.

[87] Minutes of special meeting of Board of Directors, January 18, 1933. See also this Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, p. 268, note 227.

Through the exchange offer strenuously pressed upon the preferred stockholders of Interstate Equities Corporation from June 1933 to January 15, 1935,[88] The Equity Corporation succeeded in acquiring 45.3% of the total outstanding preferred shares of Interstate Equities Corporation.[89] As indicated above in each instance the Interstate Equities preferred stockholder was yielding up a preferred stock with a $50 par value, which prevented inroads upon the invested capital of the preferred stock by the payment of dividends from a paid-in surplus. Furthermore, since the investor through the exchange had become a preferred stockholder of Equity Corporation his capital was subjected to distribution not only to those preferred stockholders who had been preferred stockholders of Interstate Equities Corporation but to all who now held preferred stock of The Equity Corporation.

The preferred stockholder of Interstate Equities Corporation observing that The Equity Corporation preferred stock had a *liquidating value* of $50.00 like his own share of Interstate Equities Corporation preferred, might not have appreciated the possible consequence attributable to the fact that the *par value* of The Equity Corporation stock was only $1.00 per share.

On June 1, 1935, The Equity Corporation made a current dividend payment aggregating $54,216.15 to the holders of its preferred stock.[90] The company had not earned this dividend. In fact, there were arrearages of accumulated dividends on its preferred stock totaling $416,880.00 as of March 1, 1935.[91] The company paid the dividend out of a large capital surplus created in the manner outlined above; by allocating the greater part of the value of both preferred and common stocks obtained by means of exchange offers (and outright purchases) to paid-in surplus.[92] The major part of this capital surplus, $13,470,843.78, was surplus so derived from the acquisition of preferred stock issues.[93]

Payment of this dividend was not only a return to preferred stockholders of a part of their original invested capital but constituted a discrimination between stockholders due to the fact that a current dividend was paid when where were unequal arrearages of accumulated dividends. The Equity Corporation preferred stock which had been issued in the earlier exchanges was more in arrears than that issued in the later exchanges. In some instances the accruals dated back as far as March 1, 1933.[94] One form of statement employed by

[88] The pressure devices used by The Equity Corporation in effectuating its exchange program are described in this Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VIII, pp. 229–292.

[89] Through shares acquired by purchase The Equity Corporation raised its holdings of preferred stock of Interstate Equities Corporation to approximately 62.8% of the total. (Op. cit. supra, note 87, Part VII, p. 293.)

[90] Op. cit. supra, note 83, Commission's Exhibit No. 794 (p. 14).

[91] Id., Commission's Exhibit No. 849.

[92] "Equity valued the total consideration received for its stocks and $743,063.39 in cash through December 31, 1935, at $18,711,149.83. By a process of allocating to capital only an amount equal to the par value of stock issued, namely, $780,759.44, Equity was able during this period to build a capital surplus on its books of $17,187,327.00" (op. cit. supra, note 88, Part VII, p. 268, note 227).

[93] Op. cit. supra, note 83, Commission's Exhibit No. 777.

[94] Id., Commission's Exhibit No. 1039.

The Equity Corporation to induce acceptance of its exchange offers created the impression that dividend payments would shortly be made on The Equity Corporation preferred stock offered in exchange. Nevertheless, the preferred stockholders of Interstate Equities Corporation who accepted the exchange offer of June 1933 or shortly thereafter had suffered an accumulation of arrearages [95] on their preferred stock up to June 1, 1935. Instead of paying off such arrearages, The Equity Corporation paid part of a current dividend, as stated above, to all the holders of The Equity Corporation preferred stock at that time—to those who had just received The Equity Corporation preferred stock on which there were no arrearages equally with that preferred stock on which arrearages had accumulated for two years. Thus in accepting the $1.00 par value preferred stock of The Equity Corporation in exchange for their $50.00 par preferred of Interstate Equities Corporation, the exchanging stockholders not only made the capital contributed by them available for distribution as dividends but enabled the common stock control of The Equity Corporation to distribute such dividends in a manner prejudicial to them as early acceptors of The Equity Corporation stock.[96]

2. UTILIZING THE REDEMPTION "CALL"

The ability of the "common stock control" to reacquire preferred stock at a fixed "call" price or through repurchases on the market or by means of offers of conversion into common stock, frequently afforded the management the opportunity to utilize the funds of the company in a manner detrimental to the interests of the company as a whole, or prejudicial to the preferred stockholders as a class, but useful to promote particular objectives of the sponsors of the company.

The market premium on common stock of investment companies, generally characteristic of the pre-market-collapse days, provided

[95] Op. cit. supra, note 88, Part VII, pp. 251 and 272.

[96] To put itself in a position to pay a current dividend or part thereof before paying up the arrearages of dividends The Equity Corporation had to effect a charter amendment. At a stockholders' meeting on April 25, 1935, the charter was amended permitting the payment of "current dividends on Preferred Stock for any dividend period * * * irrespective of whether all previously accumulated dividends on preferred stock shall have been paid in full" (Reply to the Commission's questionnaire for The Equity Corporation, Pt. I, Exhibit K–18, K–19, and Commission's Exhibit No. 1072).

On May 6, 1935, The Equity Corporation was advised by its counsel that it could legally pay current dividends out of the "paid-in surplus" created pursuant to the Delaware Law. Part of the opinion reads as follows: "You have requested our opinion with respect to the propriety of your Corporation paying current dividends on your Preferred Stock out of your capital surplus.

* * * * * * *

"We understand that at the time of each issuance of stock of your corporation the directors expressly stated that $1.00 of the consideration received for each share of Preferred Stock should be allocated to surplus, and that 10¢ (or in a few instances an amount in excess thereof) of the consideration received for each share of Capital Stock should be deemed capital, and the balance allocated to surplus. We further understand that the paid-in capital surplus now shown by the Balance Sheet of your Corporation was created by the aforesaid actions of the Board of Directors of your Corporation.

"On the basis of the foregoing, we are of the opinion that your Corporation may properly pay current dividends on the outstanding shares of your Preferred Stock out of your paid-in capital surplus created as hereinbefore set forth." (Derived from supplementary informatio supplied the Commission for The Equity Corporation.)

investment company managements with a persuasive factor for inducing preferred stockholders to relinquish their greater security and asset claims and accept in exchange common stock. On the other hand, the same factor made it feasible for the management to pay to preferred stockholders from the treasury of the company, large premiums above the liquidating value of the shares, in order to avoid a conversion of the preferred stock into common stock. Such a conversion would interfere with the technique currently employed by the management of stimulating the market price of the common stock while unloading the common stock upon the public by off-the-market sales. The fact that the market price of the common stock was frequently far above its asset value while the market price of preferred stock substantially exceeded its liquidating value only in the rarest instances,[97] gave the management the opportunity for arranging trades, exchanges, conversions, and repurchases of the several classes of securities so as to further particular plans for personal advantage evolved by the managements.

That the function of an investment company should be to serve the investors as a body rather than to seek to pit the interests of one class of security holders against the other is elementary. The evil consisted fundamentally in the fact that the management consummated deals with and between its own stockholders instead of limiting itself to conducting the investment business on behalf of its security holders as a whole. As the "management" in these instances was frequently itself an operator or speculator in the stock of the investment company, the deals put through by it were generally calculated to yield a benefit to the insiders and tended to be prejudicial to one class or other of the public investors or to the company as a whole.

In instances where the management had a personal interest in increasing the asset position of the common stock, preferred stockholders might be induced by management to convert their holdings into common stock having an asset value less than the liquidating value of the preferred stock which they were surrendering. This would result in an increase in the proportion of the assets of the company to which the common stock, held mainly by the management, was entitled and a decrease in the proportion of assets which the erstwhile preferred stockholders could claim, as well as a loss in the priority status originally possessed by the preferred stockholders. In the instances where the high market level for the common stock, artificially maintained by the management, was threatened by the conversion rights of the preferred stock, the management was in a position to dissipate the company's funds in repurchasing the preferred stock at prices far above the "call" price specified in the charter of the company. It might be noted that in the first type of situation the interests of the management would be served by the encouragement of conversion on the part of the preferred stockholder; in the second type, by the avoidance of a conversion. It is quite natural that the activities of the company in this matter of redemptions, repurchases, and conversions should be directed into

[97] See Part Two (House Doc. No. 70, 76th Cong.) of the Commission's report, Ch. IV, pp. 320–4. Where the preferred stock carried no conversion rights and was not "under water," the variation of market price from liquidating value was comparatively small.

the channels favorable to the particular designs of the management. Illustrations will be presented of the use, by the management of an investment company, of a redemption "call" to bring about the conversion of preferred stock into common stock of a substantially smaller asset value, and of the activities of the management of an investment company to avoid conversion of this stock by repurchase of the preferred stock at a premium over the liquidating value. It will be shown that in each instance the course of the activity of the company coincided with the particular interests of the management.

a. Shifting of Assets Between Security Holders by Using a Redemption "Call" to Effect Conversion of Preferred Stock Into Common Stock at an Asset Loss to the Converting Preferred Stockholders.

(1) FINANCIAL AND INDUSTRIAL SECURITIES CORPORATION

Financial and Industrial Securities Corporation was organized in Maryland on December 24, 1925, for the purpose, according to the sponsors, of enabling members of the public to participate in the prospective success of the investment enterprises of Ralph Jonas and his associates, under whose guidance the Manufacturers Trust Company, a large New York bank, and several other large enterprises had experienced a period of successful operation.

The original authorized capitalization of the Company consisted of a $100 par value preferred stock, a Class A common stock, and a Class B common stock.[98] In 1927 the Class A and Class B common stock was reclassified into a single issue of common stock.[99] By the close of February 1927, the investment company had derived $37,425,000 from the issuance of 250,000 shares of preferred stock, 1,037,500 shares of common stock, option warrants to purchase 210,000 shares of common stock at various prices, and 100,000 exchange warrants. Each of these exchange warrants entitled its holder to convert preferred stock into common stock in the ratio on or before February 20, 1928, of two and two-ninths shares of common shares for each share of preferred and in the ratio on or before February 28, 1929, of two shares of common stock for each share of preferred stock.[100]

At the inception of the investment company Ralph Jonas and associated interests[101] had acquired 1,037,500 shares of its common stock in exchange for securities having a market value of $12,425,000.[102]

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[98] Public Examination, Financial and Industrial Securities Corporation, Commission's Exhibit 2096.

[99] Id., at 18910 and Commission's Exhibit No. 2096.

[100] Id., at 18905 and Commission's Exhibit No. 3002.

[101] Principally the New Brunswick Chemical Company, in which Ralph Jonas had a substantial interest, and in which George U. Tompers, a vice president of the manufacturers Trust Company, and others also had a financial interest (id., at 18900).

[102] Id., at 18906–9. The securities transferred to Financial and Industrial Securities Corporation by Ralph Jonas and his associated interests were principally large blocks of the stocks of Manufacturers Trust Company of New York, National Liberty Insurance Company of America, The Baltimore American Insurance Company of New York, and Peoples National Fire Insurance Company (ibid.).

The remainder of the capital of the investment company had been contributed by the public, which had purchased all of its preferred stock.

As a result of the exercise of warrants to purchase common stock and the conversion of preferred stock into common stock and the distribution of a 5% stock dividend bv the exercise of exchange warrants, Financial and Industrial Securities Corporation had the following capitalization as at January 31, 1928:

7% preferred stock: 154,458 shares	$ 15,445,800.00
Common stock: 1,563,863½ shares	27,667,991.91

The distribution of the shares of common stock to January 31, 1928 was substantially as follows:[103]

Sold to Ralph Jonas and Associates	1,037,500
Sale of common stock in 1927	240,061
Common stock issued on the conversion of preferred stock	212,315 5/9
5% stock dividend in 1927	73,986 19/20
	1,563,863+

The amount of common stock which Ralph Jonas and his associates had originally secured constituted approximately 70% of all the common stock outstanding on January 31, 1928.[104] While Ralph Jonas and his associated interests had not retained all of their common stock, it is clear that on January 31, 1928 they still held more than 50% of the outstanding common stock.[105]

On December 1, 1928 the management of Financial and Industrial Securities Corporation caused the company to take very significant action in regard to the outstanding preferred stock. The preferred stock was subject to call for redemption at the option of the company, at $110 per share plus accrued dividends. On December 1, 1928, Financial and Industrial Securities Corporation proceeded to exercise this right to call the preferred stock for redemption at $110 per share plus accrued dividends. However, in addition to a formal notification of the exercises of its call rights the company offered the preferred stockholder an alternative, valid for only 10 days, to convert his preferred stock into common stock on the basis of nine-tenths of a share of common stock for one share of preferred stock.[106] Practically the entire issue of 150,000 shares of preferred stock, namely, 142,628 8/9 shares, accepted the conversion offer; only 7,475 1/9 shares of preferred stock accepted the redemption in cash.

It seems fairly clear that the management, in demanding the surrender of the preferred stock at the redemption price and offering the conversion as an alternative, was primarily interested not in effecting the redemption, but in securing the conversion. One indication that the management desired to promote the conversion was the fact that the notice stated that the common stock to be issued on the conversion, deliverable on or after December 12, 1928, would carry dividends for the full quarterly period ending December 31,

[103] Id., at 18905 and Commission's Exhibit No. 3006.

[104] Ralph Jonas and his associates would have received, by January 1928, additional common stock as their participation in the 5% stock dividend.

[105] Op. cit. supra, note 98, Commission's Exhibit No. 3021. See infra, note 123.

[106] Id., Commission's Exhibit No. 3008.

1928,[107] and that a $1 regular and a $1 extra dividend for that period was declared.[108] Were the sole object of the management the retirement of the preferred stock there would have been no need of coupling with the redemption call the alternative of converting the preferred stock into common stock. The notice specified that if the preferred stockholder did not, within 10 days, accept the conversion, the company would exercise its "call" privilege to terminate his investment participation in the company.

The redemption did not hold any promise of profit to the management—in fact, it would have reduced the leverage of the common stock without increasing the asset value of the common stock. On the other hand, the conversion—as will be seen—secured to the common stockholdings of the management interests a gain of several millions of dollars in asset value. The gain in asset value by the common stockholdings was derived from an equivalent loss in asset value suffered by the preferred stockholders who converted their preferred stock into common stock.

The reason that the conversion alternative was accepted by the vast majority of preferred stockholders, despite the fact that the preferred stockholders suffered a substantial asset loss in the exchange, may perhaps be explained by the discrepancy between the current market and asset value of the common stock and by the fact that, whereas the ordinary investor may have been familiar with the market quotations, he was not apprised of the current asset value. On the basis of prevailing over-the-counter market prices of Financial and Industrial Securities Corporation common stock the conversion offer appeared attractive. From January through December 1928, the over-the-counter market price of the common stock had ranged from 109½ to 138½. During the pendency of the offer (December 1 to December 10, 1928), the market price of the common stock ranged from 129 to 133.[109] The asset value of the common stock, on the other hand, was much lower. The precise asset value of the common stock on December 1, 1928, is not ascertainable, but the statements of the company show the asset value of the common stock on January 1, 1928, as $45.91 a share and on December 31, 1928 (after the consummation of the conversions which increased the asset value of the common stock) as $65.32 per share.[110] Thus while the holder of a share of preferred stock, having a redemption value of $110, received an equivalent in the current market value of nine-tenths of a share of common stock, he received a security having less than half of the asset value of the security which he was surrendering. Whereas the preferred stockholder may have known the current market quotation of the common stock,[111] he may not have been acquainted with the current asset value of the common stock. Ralph Jonas testified that there was no reference to the asset value of the common stock in the redemption and

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[107] Ibid.

[108] *Poor's Cumulative Service* for 1928, Vol. 4, p. 289.

[109] *The New York Times,* daily over-the-counter quotations.

[110] Op. cit. supra, note 98, Commission's Exhibits Nos. 3006 and 3020.

[111] Investors had witnessed the steady advance in the market price of the common stock of Financial and Industrial Securities Corporation and had received letters from the Manufacturers Trust Company and Harris Ayers & Company stressing the profits which had accrued to purchasers of the 7% preferred stock who had exercised the attached common stock warrants (id., at 18941 and Commission's Exhibit No. 3002).

conversion offer of December 1, 1928.[112] The latest statement of the company indicating its asset position was one issued for January 31, 1928, almost an entire year prior to the offer. Mr. Jonas, while admitting, in the light of experience since 1928, that informing the stockholder of the asset value of the common stock on a conversion offer is the "desirable" practice, asserted that at the time of the instant conversion offer such a practice was not prevalent:[113]

> I think it is a desirable thing, as I say, in view of the experience that we have had and the further light that we have had, to state in any conversion offer the asset position of the company, and surely on the right of the preferred stockholder or bondholder in line with what I have already indicated. * * * as far as I know, it certainly was an unusual thing, and as far as I know, it had never been the practice to state on the conversion the asset value at that time. I know of no company which had done so.

As has been stated, holders of 142,628⅝ shares of the preferred stock elected to have their preferred stock converted on the basis of nine-tenths of a share of common stock rather than accept the redemption alternative.[114] It should be noted that at the same time that the preferred stock was being exchanged for nine-tenths of a share of common stock, a share of preferred stock, when accompanied by an exchange warrant, was still receiving two shares of common stock for each share of preferred stock.[115] The holders of the 142,628⅝ shares of preferred stock which were deposited for conversion yielded up a security which had an asset value of $110 per share for an amount of common stock (nine-tenths of a share) which, on December 31, 1928, when the conversions were consummated, had an asset value of $58.79.[116] The preferred stockholders thus surrendered to the common stock, held largely by the sponsors, more than $7,000,000 in asset value.[117]

Ralph Jonas testified that the management was granting the preferred stockholder a conversion based on market quotations alone and not on asset value, that the conversion entailed a sacrifice of asset value on the part of the preferred stockholder and that this

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[112] Id., at 18946.

[113] Id., at 18944–46. It should be noted that Section 3 (a) (9) of the Securities Act of 1933 exempts from the registration requirements of the Act "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."

[114] Id., at 18938, and Commission's Exhibit No. 3006.

[115] Id., Commission's Exhibit No. 3002.

[116] Id., Commission's Exhibit No. 3006.

[117] The asset loss to the preferred stockholdings and corresponding asset gain to the common stock outstanding prior to the issuance of the new common stock on the conversion is computed as follows:

Total liquidating value of 142,628⅝ shares of preferred stock, at $110 per share		$15,689,177.78
Number of shares of common stock issued in exchange	128,366 shs.	
Asset value of a share of common stock on Dec. 31, 1928	$65.32	
Total asset value on Dec. 31, 1928, of the common stock issued in exchange for the preferred stock surrendered		[a] 8,384,867.12
Difference between the asset (liquidating) value of preferred shares surrendered and the asset value of common stock received		[a] 7,304,510.66

[a] The figure for the total asset value of the common stock received in exchange and the resulting figure for the asset loss sustained by the preferred stockholders is applicable to Dec. 31, 1928. Corresponding figures for Dec. 20, 1928, the last day for the conversion, cannot be precisely computed, since the asset value of the common stock on that day is not ascertainable.

sacrifice in asset position enured to the benefit of the other common stock:[118]

Q. * * * So that there was a sacrifice by the preferred stockholder of an asset value. He was changing its position, it is true. Isn't that so?

A. Yes; he was changing it into common stock or cash as he desired.

Q. And in changing his position he was making a sacrifice of asset value?

A. Well, if you want to regard it that way. He was changing his asset position in favor of the market opportunity.

Q. And, of course, that sacrifice of asset position inured to the benefit of the other common stock?

A. That would be so.

Thus, by December 31, 1928, Financial and Industrial Securities Corporation, which had commenced operations with three classes of stock (Class A common, Class B common, and preferred stock) had become a single-security company. The public, which had invested in the company primarily on a preferred basis, had been reduced to the same status of security ownership as the sponsors. A comparison of the status of the original investment of $25,000,000 by the public in the preferred stock, with the status of the original investment of $12,425,000 by the sponsor interests in the common stock shows that as of December 31, 1928, the former preferred stockholders who had contributed about 60% of the net capital,[119] now held approximately 349,952 shares of common stock in place of their preferred stock,[120] or about 20% of all $1,701,630\frac{19}{20}$ shares of common stock outstanding,[121] while the amount of common stock originally procured by the sponsor interests for a contribution of about 30% of the net capital, now constituted ownership of approximately 65% of the company and its assets.[122] Not all of the 1,037,500 shares originally taken up by the sponsor interests

[118] Op. cit. supra, note 98, at 18939–40.

[119] The total amount of capital raised by the investment company from its inception on December 24, 1925, up to and including December 31, 1928, had been as follows (id., Commission's Exhibit No. 3006):

Sold for cash:	
250,000 shares of 7% preferred stock	$25, 000, 000. 00
240,192 shares of common stock	5, 618, 341. 96
Total amount of capital contributions made in cash	30, 618, 341. 96
Issued in exchange for portfolio securities:	
1.037,500 shares of common stock	12, 425, 000. 00
Aggregate amount of capital contributions	43, 043, 341. 96
Less: Par value of $7,475\frac{1}{9}$ shares of preferred stock called for redemption	747, 511. 11
Net Capital Contributions	42, 295, 830. 85

The investment company had also issued a 5% stock dividend which was carried on its books at a nominal amount of $73,986.95.

[120] See the following:

Common stock issued on the conversion of 99,896 shares with exchange warrants	221, 586 shares
Common stock issued on the conversion of $142,628\frac{8}{9}$ shares of preferred stock pursuant to the exchange offer of Dec. 1, 1928	128, 366 shares
Total	349, 952 shares

[121] Op. cit. supra, note 98, Commission's Exhibit No. 3006. In addition, the holders of $7,475\frac{1}{9}$ shares of preferred stock had had their shares redeemed at $110 a share, receiving the sum of $822,262.22 in cash.

[122] Including the 5% stock dividend on the 1,037,500 shares of common stock (id., Commission's Exhibit No. 3006).

were retained by them down to December 31, 1928. The sponsor interests during 1927 and 1928 had recouped at least the amount of their original investment of $12,425,000 in the common stock by selling to the public from time to time blocks of their common stock at high prices.[123] Nevertheless, on December 31, 1928, after the retirement of all the preferred stock the amount of common stock still in the possession of the sponsor interests constituted approximately 45% of the outstanding stock.[124] Had the company been dissolved on that date, the sponsor interests would have received as their distributive share 45% of the total assets of the company. While the sponsors did not liquidate the company at this time, they did shortly thereafter sell all the assets of the company to The Goldman Sachs Trading Corporation and received as their share of the consideration for the sale about a million shares of the stock of The Goldman Sachs Trading Corporation.[125] This transaction will be referred to again hereafter.

The method by which the sponsors of Financial and Industrial Securities Corporation were able to transmute a 30% contribution to the net capital into the unencumbered ownership of 45% of the assets of the company, while recouping the amount of their original investment by the sale of part of their stock, illustrates the possibilities in connection with a multiple-security capital structure. The so-called "senior money" supplied by the public supplies a leverage for the common stock. This leverage, under favorable market conditions, tends to impart a substantial market premium to the common stock and creates a considerable disparity between the market value and the asset value of the common stock. The average investor is likely to be familiar with market quotations and their significance but not with the significance of asset values. In fact, in many instances the investor may not have had any knowledge of the current asset value. The sponsor, to whom asset value is a much more concrete concept, is frequently in a position to influence the senior security holder to yield up some part of his priority interest in the assets of the company through the lure of greater transient market value.

The sponsor interests were able to utilize this shift of asset value in favor of the common stockholdings, which the sponsors procured through the conversion of the preferred stock, shortly thereafter when a merger of Financial and Industrial Securities Corporation was effected with The Goldman Sachs Trading Corporation on an asset value basis.[126] The market premium over asset value of the Financial and Industrial Securities Corporation stock was much greater than that of The Goldman Sachs Trading Corporation stock and the sponsors of The Goldman Sachs Trading Corporation refused to ac-

[123] During 1927 and 1928 Ralph Jonas and his associates sold through the Manufacturers Trust Company approximately 206,000 shares of the common stock of Financial and Industrial Securities Corporation at prices varying from $82.50 to $115.95 per share. If it be assumed that these shares were part of the 1,037,500 shares purchased from the investment company by Ralph Jonas and his associates at an average cost of $12 a share, the profit to the sponsor interests on these sales was approximately $20,000,000 (id., Commission's Exhibit No. 3021).

[124] Public Examination, The Goldman Sachs Trading Corporation, at 16281–2.

[125] Id., at 16281.

[126] Id., at 16157–8.

cept the higher market premium of Financial and Industrial Securities Corporation common as the basis of the exchange.[127] Waddill Catchings, the president of The Goldman Sachs Trading Corporation, testified that the sponsors of Financial and Industrial Securities Corporation agreed to accept The Goldman Sachs Trading Corporation stock as though it were of a market parity with the Financial and Industrial stock and conceded that it was unlikely that the public stockholders of Financial and Industrial Securities Corporation would have consented "to exchange their stock marketwise for a stock that was selling at half the price it [their own stock] was selling for before they made the exchange."[128] However, before the merger was submitted to the Financial and Industrial Securities Corporation stockholders the market price of The Goldman Sachs Trading Corporation stock had accomplished the phenomenal feat of rising 84½ points in four days.[129]

From February 4 to February 7, 1929, inclusive, a joint trading account in the stock of The Goldman Sachs Trading Corporation composed of The Goldman Sachs Trading Corporation and Delmar Capital Corporation, one of Mr. Jonas' "office corporations,"[130] purchased on the New York Curb Exchange 174,400 shares of the stock of The Goldman Sachs Trading Corporation at a total cost of $33,325,000 and sold only 4,500 shares at approximately $975,000.[131] Its purchases over the short period constituted 66% of total trading on the stock in the New York Curb Exchange.[132]

Mr. Catchings denied that the account was formed or operated for the purpose of putting up the price of the stock and urged that this market price would have been attained even in the absence of the account.[133] He agreed that the mere fact that the Financial and Industrial Securities Corporation interests were willing to accept an exchange on an asset value basis and to disregard the initial discrepancy in market value would have brought the market premium on The Goldman Sachs Trading Corporation stock to a parity with that of Financial and Industrial Securities Corporation.[134]

What is most significant about this transaction is the fact that when "insiders" were dealing with the public investor they retired his preferred stock on a market basis and at an asset loss to the investor; when dealing with the "inside" interests of another company an asset basis was recognized as the proper criterion and the market value, either naturally or by artificial stimulation, rose in four days to coincide with the asset status.

It should be noted that the disparity between the market and asset value of common stock may be utilized by sponsors of investment companies to promote opposing courses of action each of which facilitates the particular plans of the management. In this case where the conversion of the preferred stock into common stock would result in

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[127] Public Examination, Financial and Industrial Securities Corporation, at 16272.

[128] Op. cit. supra, note 124, at 16138 and 16158.

[129] Id., at 16157 and 16144.

[130] Id., at 16126.

[131] Id., at 16142.

[132] Id., at 16143. For a detailed discussion of this trading in The Goldman Sachs Trading Corporation stock see Ch. IV of this part of the report, pp. 1522 et seq.

[133] Op. cit. supra, note 124, at 16131–2.

[134] Id., at 16132 and 16317.

an asset gain to the common stockholders of the sponsor interests, the management voluntarily tendered such a conversion privilege to the preferred stockholders. In the case of Central States Electric Corporation [135] an absolute right of conversion possessed by the preferred stockholders threatened to interfere with the market activities of the sponsors in the common stock and the management paid out large premiums to preferred stockholders to prevent the conversion right from being exercised.

b. Nullification of Open-end Privilege Relating to Preferred Stock

Most investing companies have imposed upon their preferred stock the condition that the preferred stock must be surrendered when the company offers a "call" price fixed in the charter of the company, or in the resolution authorizing the issuance of the stock.[136] The "call" price is generally from 2% to 10% above the principal sum to which the preferred stock is entitled upon dissolution. This provision permitting the company to "call in" the preferred stock at a fixed figure is naturally a privilege extended to the company, not to the preferred stockholder. A provision permitting redemption of preferred stock, at the option of the holder, has been extremely rare.[137] Open-end investment companies, which are almost exclusively simple structures companies, are of course characterized by the provision that the holders of the shares may at their option surrender the shares to the company at approximately the net asset value. The multiple-security company, as above stated, does not generally extend such a privilege to the senior security holder.

(1) CHAIN & GENERAL EQUITIES, INC.

Chain & General Equities, Inc., although a general investment company of the closed-end type, granted its preferred stock (as well as the common stock) upon the issuance thereof, a qualified "open-end" or redemption privilege. This provision embodied safeguards and advantages undoubtedly attractive to the preferred stockholders investing in the company. After the issuance thereof the "common-stock control" first whittled away, and ultimately completely eradicated, this privilege.

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[135] See infra, pp. 1762–70, for a discussion of the relationship between the operations of the management of Central States Electric Corporation in the common stock and the repurchases of preferred stock by that company.

[136] An examination of the questionnaire replies for 161 investment companies showed that out of 89 companies issuing preferred stock, 83 made provision for the redemption of the preferred stock.

[137] Dewing, A. S., *Financial Policy of Corporations* (3d revised edition, 1934), p. 51, notes, in connection with corporations generally, that the redemption provision permitting redemption at the option of the preferred stockholder, and a somewhat similar provision directing the retirement by the investment company of a certain number of shares each year, date back to the World War period; that they were conceived to implement the rights of preferred stockholders and to serve as an important selling point in the distribution of these securities; that the difficulties attendant upon meeting the compulsory redemption provisions and those allowing redemption at the option of the stockholders resulted in most cases in the exclusion of such provisions in the charters drafted after 1925.

Article M of the charter of Chain & General Equities, Inc. originally contained the following provision:[138]

The corporation agrees to purchase to the extent of its surplus, if any, any preferred stock at par value less the sum of one (1) dollar per share and any common stock at its liquidating value (as hereinafter defined in this certificate of incorporation) less one (1) per centum thereof, offered by the holders of the certificates thereof, but in no event shall the corporation be bound to purchase in any one month more than one (1) per centum of the par value of the preferred stock then outstanding nor more than one (1) per centum of the liquidating value of the common stock then outstanding, the first presented as determined by the board of directors to be the first purchased.

A paraphrase of this provision, included in the prospectus of Chain & General Equities, Inc.,[139] served as a representation upon which the investors might well have relied and which, no doubt, substantially aided the sale of the stock. The company was a Delaware corporation organized in February 1929 by Childs, Jeffries & Co., Incorporated, a Massachusetts corporation engaged in the investment security business.[140] Mr. Dudley Childs, associated with Childs, Jeffries & Co., Incorporated, the sponsor, conceded that the object of the provision was to make the investor feel independent of the market price of his stock:[141]

Q. But he always had the comforting feeling that if at some subsequent date he wanted to get out, out of the Chain & General Equities trust, he would not be relegated to what the market value of the stock was, which might be selling at a substantial discount, and he could always come in and get the actual value, liquidating value, of his common stock, less one percent, and get par value for the preferred stock; isn't that so?

A. That is what we were trying to set up for him.

The sponsor immediately consummated three contracts with the company: a distribution contract, a stock option contract, and a management advisory contract. The investment company issued 40,000 shares of its convertible preferred stock, Series A, at the par value of $100 per share and 160,000 of no par common stock to the sponsors under the distribution contract, which was not a firm commitment but an undertaking to find purchasers. The company received $8,000,000 net proceeds from this sale, $100 for each share of the 40,000 shares of preferred stock and $25 for each share of the 160,000 shares of no-par common stock. Childs, Jeffries & Co., Incorporated, received a gross commission of 6% on all the sales amounting to more than $400,000. The management "took down" at least $1,000,000 worth of common stock.[142] The $25 per share received for the common stock was

[138] Public Examination, The Equity Corporation, at 1719 and Commission's Exhibit No. 219.

[139] Id., at 1720 and 1727, and Commission's Exhibit No. 221:

The corporation upon request will repurchase out of surplus preferred stock at par less $1 and common at its liquidating value less 1%, provided it shall never be required to repurchase in any one month more than 1% of par preferred outstanding, nor more than 1% of liquidating value of common outstanding.

[140] Id., at 1716, and Commission's Exhibit No. 219.

[141] Id., at 1728.

[142] Id., at 1725 and 1732-5.

allocated as follows; $20 to "capital" and $5 to "paid-in surplus."[143]

It should be noted that the company at its inception provided itself with a surplus which could be utilized for the redemption of the preferred stock. Article M did not distinguish between "paid-in surplus," "capital surplus" or "earned surplus." The prospectus stated that of the proceeds of $25 per share of common stock, $5 was allocated to surplus.[144] It was clearly the objective of the promoters to give an immediate appearance of reality to the privilege of redeeming from surplus by at once creating such a surplus.

Until the collapse of security market values in October 1929 the optional redemption privilege was permitted to remain unchanged. There would naturally be no reason for the preferred stock to avail itself of an optional surrender at a price less than the current market. The significance of this provision lay in the fact that it accorded the preferred stock a certain amount of protection in the event that the market price declined while the company had a surplus.

By February 1930 the market price of the preferred stock had fallen substantially below the par value of $100 per share. The assets of the company were sufficient, however, to cover fully the preferred stock and furnish a positive asset value for the common stock. Furthermore, a surplus existed. It had been created by a reduction of the capital of the common stock from the former stated figure of $20 per share to $1 per share.[145] Market conditions were such that the exercise of the redemption privilege by the preferred stock might be anticipated. It was at this time, February 25, 1930, that the first amendment of Article M was approved at a special meeting of stockholders.[146] The effect of the amendment was to make unavailable for the redemption of preferred stock under Article M a surplus due to a reduction of the common-stock capital. This constituted the first vitiation of the privilege extended to preferred stockholders by Article M. Nevertheless, this amendment did not wholly emasculate the provision. If a surplus was acquired by the repurchase by the company of preferred stock at less than the liquidating value—at a discount (but not under Article M)—other stockholders could demand that their preferred stock be redeemed from such a surplus at par less $1 under Article M. Furthermore, while the amendment disallowed redemption from a surplus created through the reduction of common capital, it did not bar redemption from a surplus that could be created through a reduction of the par value of the preferred stock.

At a meeting of the Board of Directors on September 24, 1930, a resolution was adopted defining surplus with the apparent purpose of further narrowing "the surplus" available for redemption under Arti-

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143 Id., Commission's Exhibit No. 221.

144 Id., Commission's Exhibit No. 219.

145 On January 29, 1930, shortly before the expiration of one year from the date of organization of the investment company, a plan was adopted at a meeting of the Board of Directors "for reducing the capital shares to create a surplus" with the "view of repairing the recent depreciation in the market value of the portfolio." The reduction of the capital "was to be obtained by carrying the Chain & General Equities no par common at $1 instead of the former figure of $20. The difference of $19 was to be set up as a surplus * * *" (id., at 1743).

146 Id., at 1743–4, and Commission's Exhibit No. 226.

cle M. The intended effect of this resolution was apparently to enable the company to charge off unrealized depreciation against "Profit and Loss Surplus" and "Paid-in Surplus," to one of which the discount due to repurchase of preferred stock would be credited, thus leaving no surplus which could be used for redemption.[147]

On February 3, 1931, at the annual meeting of stockholders, an amendment to Article M was passed making unavailable for redemption purposes any surplus due to any reduction "in the amount of capital" of the corporation.[148] It will be noted that the amendment of September 1930 referred only to a surplus arising from the reduction of common capital. The amendment of February 1931 made unavailable a surplus arising from a reduction of either common or preferred capital.[149] Finally Article M was eliminated in its entirety at a special meeting of stockholders on October 15, 1931.[150] The deletion of Article M was specifically provided for in the agreement between Wallace Groves and Chain & General Equities, Inc., pursuant to which Mr. Groves arranged to take over the control of the company.[151]

It is significant that throughout the period, while obstacles were being placed in the way of effectuating the provision of Article M requiring the redemption of preferred stock at $99 per share, the company was repurchasing preferred stock at large discounts. Beginning on November 14, 1929, while the redemption clause was in existence without any change,[152] the investment company repurchased 1,573 shares of its own preferred stock at prices ranging down from $99 to $92 per share.[153] Upon inquiry as to why the preferred stockholder did not get $99 for his stock under Article M, Mr. Childs explained that if the preferred stockholder "was not bright enough" to surrender his stock to the company, but sold it to a security dealer, who sold to the company's trader in the market, "he lost the opportunity." [154]

It appears that as soon as Article M was amended the market price of the preferred stock feel precipitously and the company was able to purchase the preferred stock at large discounts from liquidating value. Before the redemption provision was amended the preferred stockholders had been receiving $92 to $99 per share.[155]

Of the 40,000 shares of preferred stock originally sold in February 1931, Chain & General Equities, Inc. repurchased 25,685, or 65%, of

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[147] Id., at 1745, and Commission's Exhibit No. 227.

[148] Id., Commission's Exhibit No. 228.

[149] Id., at 1746.

[150] Id., at 1749–53.

[151] Id., Commission's Exhibit No. 8.

[152] Id., Commission's Exhibit No. 219 (p. 8).

[153] Id., at 1794, and Commission's Exhibit No. 233.

[154] Mr. Childs testified:

Q. What I can't understand is why wasn't that stockholder informed he was entitled to $99 if he came and tendered his stock under the redemption plan.

A. I don't know why he didn't know that. If he wasn't bright enough to take that up, apparently he lost his opportunity.

Q. But, after all——

A. But those that did come to us, we turned their stock in at $99.

Id., at 1796 et seq.

[155] Id., at 1794, and Commission's Exhibit No. 233.

the total number of shares at an average price of $55.01 per share for a total cost of $1,313,091.95.[156]

The large sacrifices in asset value, especially after 1929, should be noted.[157] An aggregate of $1,313,901.95 was spent on the repurchases par value over cost of preferred stock returned to the treasury.[158] of preferred stock, of which $1,255,308.05 was credited to surplus as representing the discount on preferred stock retired and an excess of Had the preferred stockholders actually been accorded the privilege granted them upon the issuance of the stock, a very substantial part of the losses which they suffered would have been avoided.

Mr. Childs pointed out that the elimination of Article M required the approval of the stockholders. He admitted, nevertheless, that

[156] Id., Commission's Exhibit No. 234. The following is a comparison of the liquidating values of the preferred stock and the average prices paid by the company in its repurchases:

Date	Asset value of the preferred stock [a]	Average annual price paid for preferred shares repurchased	Date	Asset value of the preferred stock [a]	Average annual price paid for preferred shares repurchased
3/31/29			3/31/33	55.04	
6/30/29			6/30/33	99.54	
9/30/29			9/30/33	([c])	$44.09
12/31/29		$97.57	12/31/33	67.18	
3/31/30	([b])		3/31/34	72.01	
6/30/30			6/30/34	69.77	
9/30/30			9/30/34	69.68	
12/31/30		56.15	12/31/34	72.25	71.58
3/31/31			1/15/35	71.35	
6/30/31		60.49			
6/30/32	60.43				
9/30/32	71.51	23.82			
12/31/32	54.31				

[a] Taken from company's quarterly report.
[b] $100 par value fully covered.
[c] $100 par value fully covered; accumulated unpaid dividends not fully covered.

The number of shares repurchased, by years, and the average price paid per share are shown below:

Year repurchased	Number of shares	Average price per share	Total cost
1929 [a]	1,573	$97.50	$153,489.80
1930	11,400	56.23	640,102.00
1931	1,514	60.49	91,576.25
1932	5,607	23.82	133,583.75
1933	3,848	44.09	169,641.00
1934	1,742	71.58	124,699.15
Total	25,684	55.12	1,313,091.95

[a] First purchased in November 1929.

[157] Although the common stock had no asset value subsequent to 1930, the bid and ask quotations on the over-the-counter market ranged between $0.50 and $3.00 per share from 1930 to December 1933.

[158] Op. cit. supra, note 138, Commission's Exhibits Nos. 234 and 235h–n.

the attendance at stockholders' meetings was negligible and that stockholders usually rely upon the judgment and integrity of the management.[159]

Q. Yet when Mr. Groves came into the picture that provision was eliminated completely?

A. Yes; that is right. But, of course, the stockholders approved the complete elimination of it.

Q. Do you know how many stockholders there were present at that stockholders' meeting?

A. No; I do not know.

Q. What has been your experience with stockholders' meetings, Mr. Childs, with respect to the attendance by stockholders?

A. Well, if they are dissatisfied, if they felt that Article M had been a bad thing to eliminate, I think a good many would have shown up.

Q. Well, doesn't the average stockholder rely upon the ability and integrity and the judgment of the officers and directors, and assume when they submit a proposition it is to their interest? Hasn't that been your experience?

A. A good part of the time.

Q. * * * how many stockholders have ever shown up at the annual meetings in connection with Chain and General Equities that you remember? Did anybody ever show up?

A. Oh, yes; there were three or four.

Q. Three or four?

A. Yes.

Q. And how many stockholders of record did you have at the peak, do you remember, approximately?

A. I guess perhaps 1,000 or 1,200.

That some preferred stockholders recognized the protective value of the original provision of Article M is indicated by the fact that a suit was brought, based upon the refusal of the management to redeem the preferred stock pursuant to the provisions of Article M.[160]

Q. The fact of the matter is, one of the stockholders sued to try to enforce the provisions of Article M. You remember that?

A. No.

Q. I will show you the minutes of October 8, 1930, and see if that doesn't refresh your memory as to a suit started by one of the stockholders who thought it was of sufficient consequence for him to go out and hire a lawyer to enforce it.

A. I do remember that now. I had forgotten all about it.

Q. * * * This is from the minutes of the Board of Directors of October 8, 1930:

"Michael Spaeth filed a suit against the Chain & General Equities for failure of the latter to buy up his ten shares of preferred stock out of surplus as provided by the charters. The officers refused to buy him out on the ground they had no surplus available for this purpose."

There is one stockholder who felt that was a vital matter to him; isn't that so?

A. Apparently so.

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[159] Id., at 1751–3.

[160] Id., at 1751.

c. Use of Redemption Provision by Sponsors so as to Withdraw or Diminish an Original Contribution to the Senior Capital of the Company

As has been shown in previous illustrations, sponsors of investment companies have frequently taken common stock alone for the contribution they made to the capital of the company. In some instances, however, they have taken a substantial proportion of a preference issue accompanied by common stock as the consideration for their contribution. On the subsequent appreciation of the common stock the prospect of continuing as an investor in the senior securities appears to have become unattractive to some of these sponsors. By "calling" for redemption the preferred stock which they held the sponsors were able to withdraw their original investment in the senior securities. The sponsors thereafter frequently converted the proceeds into additional common stockholdings and raised new senior capital from the public, thereby increasing the "leverage" and the profit possibilities for the holders of the common stock.

(1) OLD COLONY INVESTMENT TRUST

Old Colony Investment Trust, a common-law trust, was organized in Massachusetts by a Declaration of Trust dated January 14, 1927, under the sponsorship of Old Colony Corporation, an investment banking subsidiary of the Old Colony Trust Company. To raise funds the trustees originally issued \$1,000,000 par value of preferred stock callable at \$1,200,000, \$5,000,000 of 4½-percent Series A debentures, and 100,000 shares of common stock. The sponsor, Old Colony Corporation, purchased the preferred stock for \$1,200,000, took up \$2,000,000 principal amount of 4½-percent Series A debentures at 97, and sold them to the public for 99½. An option on the remaining \$3,000,000 of the debentures at the same price was granted to the sponsor, permitting the purchase of these debentures in blocks of \$500,000 from time to time.[161]

The common stock was issued as a bonus "which would represent the future of the enterprise." The sponsor obtained 50,000 shares for its investment of \$1,200,000 in the preferred stock and the public received the other 50,000 shares of common stock in connection with its investment of \$5,000,000 in the debentures, on the basis of 10 shares of common with each purchase of \$1,000 face amount of debentures.

The bank and the sponsor claimed to have organized the investment trust to meet the needs of their customers. The capital structure was deliberately so framed as to make the debentures "as near a prior preference stock without a maturity before the date that was indicated in it as was possible." There was an absence of such safeguards as provisions with respect to default, a touch-off clause, a sinking fund,

[161] Public Examination, Old Colony Investment Trust, at 6109–11, 6114, 6117, and 6123–5, and Commission's Exhibits Nos. 551 and 552. The original trustees were Francis R. Hart, vice chairman of the board of directors of Old Colony Trust Company, the bank; Phillip Stockton, president of the bank; T. Jefferson Coolidge, vice president of the bank; Edwin R. Marshall, vice president of the bank and president of Old Colony Corporation, the investment banking subsidiary; and F. Winchester Denio, vice president of the bank and of the investment banking subsidiary.

or requirement for consent of debenture holders to create a prior debt. There was no provision for acceleration of maturity in case of default. If interest was not paid, the holder had merely a cause of action for interest. The sponsor created this debenture because it wanted "a non-callable brokers' loan." The debentures were due in 20 years (date of issue February 1, 1927, due February 1, 1947).[162]

The sponsors contended that the broad powers vested in the management by the common-law trust are desirable since the protection of the investor depends primarily on the management. F. W. Denio, vice president of Old Colony Trust Company and of Old Colony Corporation, testified:[163]

In the first place, you have rather broader powers [in a Massachusetts trust] which we thought was desirable, because our philosophy of an investment trust was what you were buying primarily was the integrity and judgment of management in which you had confidence, and our general theory is that if you have that confidence you can generally pretty safely trust them with any powers that they wish to give themselves.

In paying for the preferred stock, the sponsor drew its check for $1,200,000 to the order of the investment trust which deposited it in the bank, Old Colony Trust Company, to the credit of the investment trust. Three or four days later the investment trust returned the $1,200,000 to the sponsor because only 2% could be obtained on that deposit from the bank. The sponsor did not execute or deliver a note to the investment trust but agreed to pay 5% on the daily balance. By this transaction the investment trust was losing 1% per annum because it was required to pay 6% on the preferred stock issued to the sponsor which paid 5% for the use of the money it delivered as consideration for the purchase of the preferred stock. Subsequently the total capital contribution of $11,500,000 of the investment trust (as will be related) was turned over to the sponsor which paid 5% interest from the moment the money was received until it was invested.[164]

To summarize, the public invested approximately $5,000,000 in non-callable 20-year debentures and received 50,000 shares of common stock as a bonus, whereas the sponsor invested $1,200,000 in preferred stock callable for that sum and received 50,000 shares of common as a bonus which entitled it to 50% of the prospective surplus profits.[165]

It should be noted that at the inception of the company while the common stock had no asset value whatever, the sponsor had secured for its contribution to the capital a preferred stock position. Subsequently, when the common stock acquired an asset value, the sponsor retired from the preferred stock position and converted its contribution to the capital (plus an additional $800,000) into common stock holdings. This the sponsor effected by calling the preferred stock, which it held, for redemption. The mechanics of the transformation were as follows:

At the inception of the investment company the common stock had no asset value. It was contemplated that $5,000,000 was ample to

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[162] Id., at 6115–6, 6119–20, and Commission's Exhibit No. 552.
[163] Id., at 6111–2.
[164] Id., at 6134–5, 6152.
[165] Id., at 6124.

start, the sponsor being "more or less in the dark" on the desirable size. However, provision was made to allow for "the issuance of further securities of any appropriate kind that might seem desirable to the management and for the best interests of the shareholders and security holders." [166]

In the fall of 1927 (the year the investment trust was created), due to the appreciation of the portfolio, the sponsor caused the company to issue rights to subscribe to two shares of common stock at $20 per share to each holder of one share of common stock.[167] The holders of the 100,000 common shares granted as a bonus (50,000 shares of common held by the public and 50,000 held by the sponsor), therefore, had a right to subscribe to 200,000 additional shares. The rights were negotiable and assignable. The price of $20 was fixed at that sum in order to adjust the cost per share of all outstanding common to the equivalent of the asset value. By exercising the rights at $20, the shareholder who had received his original common stock as a bonus would have obtained his shares of common at a cost of $13 per share, which was the asset value at that time. The market price of the common stock was around $40 per share and the sponsor stated in the annual report of the investment trust that that price was too high.

Although the sponsor had a fixed income on its preferred stock, it redeemed the preferred at the call price of $1.200,000, the amount it originally paid. The sponsor then added $800,000 and subscribed to the common shares to which it was entitled as holder of one-half of the outstanding shares of common.[168] Mr. Denio, the vice president of the bank and of the sponsor, stated: [169]

the reason we took the preferred stock out of the situation was that for the first time we were selling shares as shares, just as we had sold, or were about to sell, debentures as debentures, and not with a bonus attached to them, and we did not want the corporation to be in a preferred position, ahead of the shares which we were about to offer to the public, and we much preferred to be on a parity ourselves with the shares which the public was paying money for and to put our $2,000,000 in the lowest position, alongside their dollars.

Although the preferred was not a participating preferred, Mr. Denio contended the sponsor had the "right to subscribe to 100,000 shares of common, as a holder of the then one-half of the outstanding shares and left its preferred in." [170] When it was indicated that the sponsor's investment would have been over $3,000,000 instead of $2,000,000, if it had not surrendered its preferred stock, Mr. Denio explained: [171]

That is the result, but it was not the purpose. The purpose was to make the common stock—or to take away from ourselves any preference that we might have on the assets of that trust, ahead of the public's.

At this time the investment trust issued $2,500,000 additional debentures which were sold to the sponsor at 94 and by it to the

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[166] Id., at 6110–1.
[167] Id., at 6125–7, and Commission's Exhibit No. 551.
[168] Id., at 6127.
[169] Id., at 6127–8.
[170] Id., at 6128.
[171] Id., at 6128–9.

public at 96½.[172] This additional senior financing obviously increased the "leverage" of the common stock and the sponsor had retired entirely from a senior position.

The total contributed capital amounted to approximately $11,500,000, of which the public paid $5,000,000 for Series A debentures, $2,500,000 for Series B debentures and $2,000,000 for 150,000 shares of common stock and the sponsor contributed $2,000,000 for 150,000 shares of common stock. The result of the recapitalization and the retirement of the sponsor from its preferred stock position was to secure the sponsor a status somewhat akin to that of an operator of a margin account. It obtained the administration of a $11,500,000 fund through an investment of $2,000,000 of its own. As the sponsor did not assume the entire risk of first losses but only assumed that risk equally with the $2,000,000 of equity money put up by the public, it did not obtain the exclusive right to surplus profits but a right of participation therein equal to the aggregate participation of the public which contributed $9,500,000 to the account.[173]

(2) GENERAL AMERICAN INVESTORS COMPANY, INC.

Practically the identical technique of extricating an original investment in preferred stock and replacing the same with an investment in common stock of the company was practiced by the sponsors of General American Investors Company, Inc., organized in January 1927 by Lazard Frères and Lehman Brothers, brokers and security underwriters. The financing of this company, described in an earlier section,[174] discloses that through the redemption procedure the sponsors were repaid their temporary investment in the preferred stock and were left in undisputed control and entitled to 62½ percent of the surplus profits of the company (the capitalization of which was almost $14,000,000) with an investment on their part of approximately $4,000,000.

3. UTILIZATION OF THE PRACTICE OF REPURCHASES OF THEIR OWN STOCK BY INVESTMENT COMPANIES

As has been indicated, the managements of investment companies were able to use redemptions and conversions to promote plans dictated by the self-interest of the managements when market conditions were favorable, i. e., when common stocks, and, to a lesser degree, preferred stocks, were selling on the market at a premium above asset value. Despite a reversal of circumstances, that is, when investment company securities were selling at market prices below their asset values, the managements of investment companies were, nevertheless, able to secure advantages to themselves and promote the visitation of

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[172] Id., at 6130, and Commission's Exhibit No. 553–C. On November 30, 1927, the sponsor agreed to buy $1,000,000 principal amount of 4½% debentures, Series B, dated December 15, 1927, due December 15, 1952, and obtained an option on $1,500,000 at the same price to be exercised on or before March 1, 1928, in blocks of $500,000 principal amount.

[173] These figures do not take into account the gross commission, amounting to approximately $200,000, obtained by the sponsor in the sale of the $7,500,000 debentures to the public (id., at 6133–4).

[174] See supra, pp. 1603–7.

losses on certain categories of senior security holders by the technique of repurchases of the investment companies' own securities.

The important place of repurchase operations by investment companies during the period 1927–35 is one of the distinguishing features of their history. During those nine years the closed-end management investment companies proper and investment-holding companies studied expended in the aggregate approximately $534,000,000 to repurchase their own securities, an amount equivalent to about 13% of the total value of securities sold by these companies during this period. The ratio of the repurchases to original sales of the various classes of securities amounted to 37% of the number of shares of preferred stocks, 38% of the principal amount in the case of bonds and 5% of the total number of shares of common stocks.[175]

The extent of repurchases of their own securities was a peculiar phenomenon of investment companies, since other corporations do not ordinarily reacquire any substantial portion of their own capital issues. The explanation sometimes offered is to the effect that investment in securities generally, while remote from the usual practices of the ordinary corporation, is the very business of the investment companies. The question still remains whether such activities in its own securities and with its own security holders are any more within the contemplated or proper scope of the activities of the investment company than that of any other corporation.[176]

By the end of 1929 the open market prices for preferred stocks were generally below the amounts to which the issues would be entitled on liquidation of the company. As justification for repurchases of preferred stocks under these circumstances, investment company sponsors and managers cited the profits derivable by the investment companies from the repurchase of their securities below their asset or liquidating values, and the alleged market support rendered these issues by the purchasing policy of the companies.[177] When the asset value of a preferred stock issue is below the amount to which it is entitled on liquidation, repurchases at prices below its asset value will help the common issue by reducing its negative value or the deficit in its equity.[178] They also benefit the remainder of the senior issue by increasing its asset coverage. However, the benefit flowing to the holders of the common stock and the remainder of the senior issue is obtained wholly at the expense of the senior security holder of the investment company whose stock the company has purchased at a price below its asset value (and to whom the management of the investment company has pledged its best efforts to preserve the principal or the par amount and pay a return thereon). Thus the company

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[175] Pt. Two of the Commission's report (House Doc. No. 70, 76th Cong.), Ch. III, pp. 232–6, Table 64, p. 233, and Chart 26, p. 234. See also Ch. III of this part of the report.

[176] Pt. Two of the Commission's report (House Doc. No. 70, 76th Cong.), Ch. III, p. 232. The repurchase of bonds, while involving many of the considerations applicable to the repurchase of preferred stocks, require independent treatment because of the special features of bonds such as "touch-off" provisions and fixed interest charges.

[177] Id., pp. 236–9.

[178] Id., p. 239, note 94.

is in a position of utilizing the funds of the company to benefit one segment of its security holders at the expense, at least from the standpoint of the asset value of the securities, of the other security holders. To this must be added the important fact that the investment company, when it was engaged in repurchasing its securities on the open market, rarely brought home to the security holder the asset value of his security, which was considerably in excess of the market quotation.

It should be noted that in the case of some of the repurchases, the retiring preferred stockholder received less than the asset value of his stock while his stock was already "under water" while in other instances he received less than the asset value (and of course less than liquidating value) at a time when his stock was fully covered by assets of the company. When the senior securities are fully covered by assets, the discount obtained by the investment company on repurchases redounds wholly to an increase in asset value of the common stock. It would seem that the fiduciary relationship between management and security holder would suggest that the management should seek to deter the improvident sacrifice of the senior security holder for the benefit of the equity stock, a substantial part of which is frequently in the hands of the management itself.

The contention that repurchases on the market at a discount constitute a desirable expedient for supporting the market value in a period of deflated prices must be carefully scrutinized.[179] It might be urged that market values could be maintained as readily by reducing the selling impulse as by providing a market buyer.[180] If the investment company, at a time when the market price was substantially below the asset value, stressed the asset value[181] and concurrently openly announced its readiness to buy at the market price directly from the holders, possibly by the method of tender of pro

[179] "On November 13, 1929, in the course of general wreckage on the stock market, many companies having a surplus were asked to use such funds as they could spare for the purpose of putting in bids for their own stock * * *. Such a situation, of course, differs from the case where the Corporation, as a pooling, manipulates the price of its own shares." (Berle, A. A., Jr., Liability for Stock Manipulation, *Columbia Law Review*, Vol. 31 (1931), p. 278, note 25.)

[180] The abstention of the investment company from the role of supporter of the market would also avert a form of deception of the independent purchaser of the security:

> Commonly, the fact that the corporation is the active party is unknown * * *. The purchaser of stock at the pegged level is, it would seem, entitled to assume that this is the level at which outsiders in the market are at present buying the stock; certainly, were he informed that the real buyer at that level was the corporation, his appraisal of the security might be radically changed. The fundamental wrong here is that the corporation has interfered with a "free" market. The buyer is, in a word, buying upon representation of liquidity at a certain level; and the liquidity is, in fact, fictitious (op. cit. supra, note 179, at 275–6).

[181] An example of the circulation by a corporation of information indicating that the market price of its stock is not in line with its value is to be found in a letter circulated by the directors of the Anaconda Copper Mining Company on December 24, 1930, of which the final paragraph reads as follows:

> It may not be deemed within the province of the directors or officers of a corporation to comment or advise upon the true value of its property as compared to current prices. However, at this time of hysteria, unfounded rumor, and prevailing pessimism, we believe it is not only proper but the duty of those charged with the responsibility of managing the investments of many thousands of shareholders to call your attention to the fact that all of the mining properties of your Company developed, equipped, and constituting as a unit the largest and most valuable copper properties and copper ore reserves in the world, together with the many millions of dollars that were expended in their development and preparation for operation are, at current quotations for the stock of your Company, selling at less than nothing (op. cit. supra, note 179).

rata shares of their holdings,[182] it would very likely have a stabilizing influence on the market as the result of a restraining effect on the then fully informed investor.[183] It would thus, to a considerable extent, avert the serious losses of a substantial proportion of senior investors.

Another consideration of importance is that by repurchasing its own outstanding securities the investment company reduces its working capital. In theory, the corporate capital is presumed to be used for the business to which the corporation is primarily dedicated. The stockholder upon acquiring his interest in the company may assume that a fund of a certain magnitude, known as the "capital" of the company, is to be devoted to making profits by the exercise of the declared function of the company. The echo of this theory is to be found in the common provision of state laws to the effect that purchases of its own stock may be made by a corporation out of "surplus" only.[184] The intended objective of such provisions is to segregate at least some part of the assets of the company for the conduct of its ordinary business.

However, with the advent of artificial definitions of "capital," the development of the mechanism of paid-in surplus, the voluntary reduction of capital, and the facility of reducing the assets to cash,[185] this purported limitation upon repurchases became almost meaningless in the case of investment companies. By the terms of the statutes and charters, the management has usually been able (with or without the aid of a vote of shares under its control) to decide what part of the assets of the company shall constitute the "capital" which is not to be available for the purposes of repurchases and to remain intact for the essential business purposes of the company. If the management of an investment company is so minded, it could arrange to expend a substantial part of the assets of the company—not only such assets as constitute surplus profits but such as have been designated paid-in surplus—for repurchasing and retiring preferred stock at a loss in

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[182] A general offer of this nature to all investors would avoid the favoritism occasionally extended to "insiders" holding senior securities.

The Committee on Stock List of the New York Stock Exchange, in attempting to circumscribe the practice of repurchase by investment trusts made the following tentative ruling in May 1931:

> The reacquisition of outstanding preferred shares would appear to be unobjectionable—
> (a) for the purpose of retirement;
> (b) for the purpose of resale under proper provisions to management in connection with management plans;
> (c) for the purpose of reissue in connection with plans of consolidation or merger; provided that in each instance the stock reacquired had been purchased at a fair price, and that its reacquisition had not impaired substantially the equity behind any outstanding securities senior to it in character.

It further stated:

> Nothing in the foregoing is intended in any way to suggest the approval of investment trusts carrying on operations in the nature of trading in their own securities.

[183] Some part of the stock offered on the market comes from "distress" sellers who may be in urgent need of the cash. A portrayal of the asset condition of the company might not influence this type of seller.

[184] Laws of Maryland Relating to Business Corporations, Article 23, Section 50; Delaware Corporation Law, Section 19: Levy, Irving J., "Purchase by a Corporation of its Own Stock," 15 Minn. Law Review 1.

[185] See supra.

asset value to the selling stockholders and to the gain of the shareholdings of the remaining stockholders.

The major possibilities of inequities in the practice of repurchases out of contributed capital, as in the practice of payments of dividends out of such capital, are to be found in investment companies with more than one class of stock. The management, through the paid-in surplus, is able to employ the contribution of the preferred stockholder to the working capital to retire his holdings at a figure less than the amount contributed by him and less than the amount which he would receive upon a liquidation of the company,[186] and simultaneously increase the asset value of the shares of common stock. It can readily be understood that a management, which itself holds a substantial amount of the common stock of the company, might be interested in strengthening its own shareholdings by seeking to gather in the securities outstanding with the public as cheaply and as much below asset value as is possible.

The large proportion of the total assets of investment companies which was employed in the practice of repurchases of their own stock has already been noted. While it has not been possible to calculate the amount of the aggregate discounts below asset value involved in repurchases throughout the investment company field, the aggregate of known discounts below asset value, which in turn represents the extent to which the equity of remaining security holders was increased, appears to have exceeded $100,000,000. Securities repurchased by closed-end management companies proper alone were acquired by these investment companies at a cost of about $300,000,000 less than the amount originally paid by investors, which total may be taken as the estimated realized loss to those investors who sold their securities to the investment companies.[187]

Several outstanding examples of large scale preferred stock repurchase programs of investment companies will be described below to indicate (a) shifting of assets between security holders effected by repurchases at a discount and (b) interference with a free market involved in the support of the market price by means of repurchases.

Tri-Continental Corporation

On January 1, 1930, Tri-Continental Corporation and Tri-Continental Allied Company, Inc. were merged to form the new Tri-Continental Corporation, an investment company of the unrestricted management type, with assets of $75,302,000.[188] The two original companies, as well as the new company, were sponsored and managed by J. & W. Seligman & Co., a copartnership engaged in the business

[186] It should be noted that even the preferred stockholder who has held on to his shares and perhaps had the asset value or asset coverage of his stock increased by the "book profits" of the repurchases, has nevertheless suffered a diminution of the working capital of his company.

[187] Pt. Two of the Commission's report (House Doc. No. 70, 76th Congress), Ch. III, p. 239, note 96.

[188] Reply to the Commission's questionnaire for Tri-Continental Corporation, Pt. IV, Items 19 and 20 (a); Public Examination, Tri-Continental Corporation, at 18551.

of investment banking, brokerage, and underwriting.[189]

The capital stock of the new company, issued for the stock of the predecessor companies, consisted of 433,650 shares of preferred stock and 2,020,150 shares of common stock. Warrants were issued sufficient to purchase in the aggregate 1,008,650 shares of common stock. The preferred was a 6% dividend, $100 par value stock with a $100 liquidating and a $110 redemption value.[190]

The Agreement of Consolidation prohibited the company from issuing additional preferred stock on a parity with the existing preferred stock, or reissuing, selling, or otherwise disposing of any of the preferred stocks which may have been redeemed or purchased for retirement:

> * * * unless immediately after the issue, re-issue, sale, or disposition thereof, the net assets of the corporation, as determined by the Board of Directors (whose determination, in the absence of fraud, shall be conclusive) shall be equal to at least two hundred per cent. (200%) of the aggregate par value of all the shares of the preferred stock, and of all of such stock on a parity with the preferred stock then outstanding.[191]

From January 1930 until September 1931 the investment company was actively engaged in repurchasing preferred shares on the open market through the sponsor firm of J. & W. Seligman & Co. In the course of these operations there was acquired a total of 276,233 shares, or more than 60% of the total shares originally outstanding, at an average cost of $92.18 a share. During the same period 108,118 shares were resold at an average price of $90.81 a share. These repurchases were made on the New York Curb Exchange until March 1930 and on the New York Stock Exchange thereafter, where they represented approximately 85% of all reported purchases on that exchange.[192]

The effect of these repurchases in "pegging" the price level while the preferred stock of other investment companies was suffering a serious decline is described in another part of this report.[193]

A somewhat unique additional objective was claimed for this extensive repurchase program. Tri-Continental Corporation was contemplating the acquisition of another large investment company which would require the issuance of a large block of preferred stock by Tri-Continental Corporation in exchange for the stock of the other company. Tri-Continental Corporation was not in a position to issue more shares of preferred stock due to the provision in the Agreement

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[189] Public Examination, Tri-Continental Corporation, at 18516–7. At the inception of both predecessor companies and then of the consolidated company, J. & W. Seligman & Co. managed the investment companies without a written management contract. In October 1931, two years after the launching of the consolidated company, the first written management contract was consummated (id., at 18645). In reply to the Commission's questionnaire (Pt. VIII, Item 77), the company states:

> Since the organization of Declarant on December 31, 1929, the firm of J. & W. Seligman & Co., a sponsor of Declarant, has held, directly or indirectly, varying amounts of Declarant's stocks having voting power, the maximum of such holdings at the end of any year being 341,266 shares of Common Stock and 50 shares of $6 Cumulative Preferred Stock, representing approximately 14.7% of all outstanding shares having voting power.

[190] Op. cit. supra., note 189, Commission's Exhibit No. 2081, III–A, III–C.

[191] Id., Commission's Exhibit No. 2081, III–C, p. (14).

[192] Id., Commission's Exhibit No. 2088 and reply to the Commission's questionnaire for Tri-Continental Corporation, Pt. V.

[193] See Ch. III of this part of the report; see also op. cit. supra, note 189, at 18723–9.

of Consolidation prohibiting the issue of additional preferred stock unless the assets of the company after the issuance equaled at least 200% of the aggregate par value of the preferred stock. In accumulating shares of preferred stock through the repurchases, the company was providing itself with preferred stock which it could distribute in the exchange, without increase in the total outstanding amount of preferred stock. Earle Bailie, a partner in the firm of J. & W. Seligman & Co., and chairman of the board of Tri-Continental Corporation, explained this objective:[194]

* * * Why did we want to buy this stock? We wanted to buy it for several reasons. In the first place, we were discussing certain acquisitions which would need a lot of this stock. We could not issue any new preferred stock because of the coverage provision, therefore we had to get our own preferred stock by buying it in the market.

When it was suggested that the stockholders of the investment company which Tri-Continental Corporation was going to acquire were likely to be influenced by the sustained market price of Tri-Continental Corporation preferred stock, not knowing that the same was being maintained by means of the extensive repurchase program, Mr. Bailie testified:[195]

Q. This acquisition of the preferred stock, though it may have been motivated by a desire to have the wherewithal to accomplish the consolidation, had the effect, though, of maintaining the price of the preferred stock at a level, is that not true?

A. That is quite true.

Q. And the direct consequence of that was that the stockholder of the investment trust that you were going to acquire might see the price range of the Tri-Continental preferred stock was standing on an even keel while other investment securities were rapidly declining, is that not so?

A. I think you must remember that in a consolidation the terms would have been as fully stated and the liquidating values would have been quite as clear, in the consolidation that we had, so that the man who was asked to come in would know that the stock would have a liquidating value of so much.

Q. Public confidence in the investment trust is reflected in its market price, is it not?

A. At times; yes.

Q. Looking at Tri-Continental preferred, you would not deny that there was a tendency at least upon the part of some persons to say that Tri-Continental has something that the others have not got by virtue of the fact that its preferred stock was at an even keel while other comparable investment trust securities were declining, is that not so?

A. That would be a possible statement to make; yes.

Q. Yet the fact is that that even keel, or that reflected market price was directly attributable to the volume of repurchases by Seligman?

A. That is quite true.

Q. So there would be the effect, whether it was intended or not, of making Tri-Continental look good in contrast to the other similar investment companies, is that not so?

A. Following your line of suggestion; yes.

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[194] Op. cit. supra, note 189, at 18721.

[195] Id., at 18729.

Mr. Bailie, while opposing an absolute prohibition against repurchases, conceded that maintenance of the market by repurchases had the tendency to mislead those stockholders who bought and those stockholders who sold the security.[196]

Q. Is it not true that by contributing to an artificial market price of the stock it has a tendency that it may mislead certain stockholders who buy, and others who sell. Stockholders may not sell because they think the stock is strong, and then suddenly in September of 1931 the stock goes zooming down to 55. Don't you see some difficulties there, Mr. Bailie?

A. I do. I see difficulties. It is not a simple situation. It is never a simple situation when you are buying and selling, when you are buying the company's own securities. I mean there are often great advantages in it. In fact some companies' lives have been saved by doing it. I think to prohibit it would be monstrous from the point of view of the fellows who need to sell.

The contemplated consolidation in connection with which the preferred stock was accumulated failed to materialize, although about 27,000 shares of the preferred stock repurchased were used in the acquisition of the Wedgwood Investing Corporation. The company employed approximately one-third of the amount of its original assets in making repurchases, ultimately retiring approximately $18,000,000 of the preferred stock, which comprised the greater part of the repurchased preferred stock. The company made a "book profit" of about $1,000,000 by virtue of the fact that the retiring preferred stockholders received less than the liquidating or asset value of the securities.[197]

The "profit" to the company was really derived from a "redistribution" of the assets of the company among stockholders.[198] Earle Bailie testified:

Q. Of course the benefit that redounded to the company was at the expense of its own stockholders; is that not so?

A. No, Mr. Schenker. Again and again I have heard you people down here criticize [these repurchases].

Q. You did not hear me criticize. I am just stating the fact.

A. You criticize the purchase of preferred stock too cheaply. In other words, they say, "It is fair to a preferred stockholder to have the company go in and buy this stock way down in price when the liquidating value is high?" I say that is true. Then you say it is not fair to buy high, even though the liquidating value is way above it. Now, how is it unfair in this second case? I just showed you by our calculation that the common stockholder and the other preferred stockholders were $5,000,000 better off at the end of the transaction than they would have been if we had not that transaction.

Q. The point I am making is you cannot attribute that to the expert management. The only thing you did, Mr. Bailie, was to take it from stockholder A and give it to stockholder B.

A. No; we retired some $18,000,000 of the preferred stock.

Q. Then the answer is "Yes" and not "No," because when you bought these stocks you made the difference between the purchase price of the security and the asset value in your process of retiring them. What you did was you took a

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[196] Id., at 18740; compare with the observation of A. A. Berle, quoted in note 180, to the effect that support of the market by repurchase of stock interferes with a "free" market.

[197] Op. cit. supra, note 189, at 18720 and 18733.

[198] Id., at 18732-3.

security that was worth $150 from stockholder A and paid him $80 or $90 for it, and that difference you put into the treasury and distributed pro rata to your remaining stockholders.

A. That is right.

Earle Bailie, when examined on the obligation of the investment company to its security holders whose shares it was repurchasing, testified: [199]

Q. Now, we have the situation that the stockholder, who was a preferred stockholder, who went into the investment trust just to avail himself at the time of your expert judgment, finds himself in the position where this expert judgment is being used against him——

A. No.

Q. Just a moment. I have not finished the sentence.

A. Pardon me.

Q. He finds himself in the position where this expert judgment is being used against him in this respect, that you, through your volume of repurchases and at the prices of these repurchases, are seeking to induce him to sell at a price that you knew would be a good buy for you; is that not so?

A. Has it not occurred to you that it is possible that it may be good for one man to sell the stock and at the same time good for another man to buy it? This preferred stock is an example of it. From the company's point of view it was extremely useful for them to be able to buy that stock, because they were cutting the pyramid down, or making ready for the acquisition, so here was a case where it was really good for both sides, as I see it.

Q. Was there any announcement sent to the stockholders reading substantially as follows:

"Please take notice that the asset value of your stock is X dollars, its market value is Y dollars, selling at a discount of A dollars. We think that this stock is a good buy at that price, and we are preparing to buy all the stock we can get at that price. Now we tell you these facts, and after we tell you these facts, if you think you still want to sell, we are prepared to buy it."

Nothing like that was said?

A. I can not remember any such statement. We did, however, at the end of every quarter, state what we had bought, the quantities we had bought, which I think is as far as any statement like that goes that we have ever made.

Q. Of course, we have had situations here where the management sent out notices to stockholders saying, "Your stock is selling at X dollars, its asset value is Y dollars."

A. I have seen such statements.

Q. "If you still insist on selling it, we would like to get the benefit of the discount."

A. Yes.

Q. That was not done in this situation?

A. No.

Q. What difficulty do you find with such announcement to stockholders, apprising them of the fact that the management thinks the repurchase of the stock at a substantial discount is a good buy for the corporation and it might be advisable for the stockholders to hold on?

A. I would hesitate very much to advise a stockholder to hold on.

Q. Then eliminate "hold on." What investment policy can you see in that disclosure being made before the fact and not after the fact, namely, that "Our

[199] Id., at 18735–8

securities are selling at a substantial discount; we are prepared to purchase these stocks at this substantial discount, and we are telling you about it."

A. In some situations there is no difficulty at all. * * *

Mr. Bailie suggested that the effect of such an announcement would be likely to dissuade the prospective vendor from selling his preferred stock to the company.[200]

A. * * * The answer is, of course, that you do not get any stock ordinarily. The answer is then that you have got to go and call your stock at its call price There are situations, however, if one is to avoid the old methods of merger and acquisition, where, if you make that type of announcement in connection with an acquisition that you intend to make, you render the possibility of your being able to make the acquisition negligible.

Q. You think that that is an insurmountable obstacle.

A. No; I do not think it is.

To the extent to which a disclosure would deter the senior security holder from selling at a price below the asset value, the shifting of asset values between security holders of the same company would be minimized.

a. Use of Capital Assets, Not Surplus, to Retire Senior Securities With a Loss in Asset Value

(1) UNITED STATES & INTERNATIONAL SECURITIES CORPORATION

As has been previously described in connection with sponsor control,[201] and with the payment of dividends out of contributed capital,[202] United States & International Securities Corporation was financed by the public sale of installment allotment certificates consisting of one share of first preferred stock, one share of common stock, and an option warrant and by the sale to the United States & Foreign Securities Corporation, the parent investment company, of the second preferred stock, accompanied by 80% of the common stock issued.[203] The parent investment company paid in $10,000.000 for its junior position, while the distribution of the allotment certificates to the public contemplated a public contribution of $50,000,000. However, only $12,500,000, representing 25%, was paid in on the installment certificates at the time of the subscription, the balance being subject to call in three subsequent installments.[204]

From 1929 through 1935, United States & International Securities Corporation engaged in the repurchases of its first preferred stock. The essential details in connection with the repurchase operations are as follows:

[200] Id., at 18738.

[201] See supra, pp. 1598–1602.

[202] See supra, pp. 1710–22.

[203] Public Examination, United States & Foreign Securities Corporation: reply to the Commission's questionnaire for United States & International Securities Corporation, Pt. I.

[204] Reply to the Commission's questionnaire for United States & International Securities Corporation, Pt I (Exhibit D) and Pt. V.

Repurchases of first preferred stock by United States & International Securities Corporation [a]

Year	Shares	Cost	Average price	Average yearly asset value	Market price range	
					High	Low
1928	None					
1929	5,563	$369,682	$66.45	$146	$102.00	$59.00
1930	85,990	5,469,144	63.60	108	75.00	28.00
1931	71,500	2,455,192	34.30	76	60.00	17.50
1932	39,000	901,885	23.13	60	32.50	9.25
1933	36,490	1,848,730	50.66	75	65.00	17.88
1934	7,200	397,283	55.18	92	69.38	39.88
1935	600	34,259	57.10	114	80.75	41.25
	246,343	11,476,175	46.59			

[a] Compiled from information supplied in Parts IV and V of the reply to the Commission's questionnaire for United States & International Securities Corporation. Average yearly asset value is computed as the arithmetic mean of the asset values at the beginning and end of the respective years.

An aggregate of 246,343 shares of first preferred stock or 51% of the 486,543 shares issued,[205] were repurchased and $11,473,580, or 24.3% of the $47,166,125 net capital contributed by the public was used in these repurchases. The total loss to holders of first preferred stock who sold their shares to the Corporation (assuming the stock was bought by these holders at the issue price of $100 a share) was $13,160,720, or an average loss to these stockholders of 53.5% of their original investment. This amount of loss represents the measure of gain to the remaining stockholders of the company.

Approximately 63.4% of total repurchases of shares occurred in 1930 and 1931. In that period United States & International Securities Corporation did not for the most part itself repurchase its first preferred stock in the market, but repurchased these securities from its parent, United States & Foreign Securities Corporation. The parent bought up the partially paid allotment certificates in the market, paid the balance due on these certificates, detached the first preferred stock from the shares of common stock and the option warrant accompanying the same and resold the first preferred shares to United States & International Securities Corporation on a nonprofit basis. Ernest B. Tracy, president of both the parent and the subsidiary investment company, testified as follows:[206]

Q. Supposing you tell us a little bit about the repurchase of the preferred stock of United States & Foreign by the parent company?

A. The purchase of the allotment certificates?

Q. Yes.

A. United States & Foreign bought the allotment certificates. The reason they bought them was it was a good purchase at the time. They were buying them at less than liquidating value of the stock.

[205] Of the 500,000 shares originally represented by the allotment certificates 14,457 shares were canceled for nonpayment. (Reply to the Commission's questionnaire for United States & International Securities Corporation, Pt. II, Exhibit A, Schedule 8.)

[206] Public Examination, United States & Foreign Securities Corporation, at 11940.

Q. Was that the only reason?

A. That was the principal reason they were buying.

Q. What were some of the other reasons?

A. There was some doubt, as I told you this morning, between counsel as to whether or not I had the right to buy them.

Q. Whether or not United States & International had the right to buy its common stock?

A. Yes; there was some question. I don't remember what it was, and I have tried to find that since I was down there the last time, but I remember Mr. Franklin was the one that advised us that there was some doubt. I don't know whether he consulted with Clark or not.

Q. As a result, the parent company bought in preferred stocks?

A. Bought allotment certificates.

Q. And it detached the common stock and sold the preferred stock to the subsidiary?

A. Paid it up.

Q. Paid it up and sold it to the subsidiary?

A. And the subsidiary wanted to buy and bought it for retirement at the market.

Apparently the doubt in the mind of counsel related to the right of United States & International Securities Corporation to repurchase the allotment certificates which carried common stock in addition to preferred stock. The testimony does not contain any suggestion that there was doubt concerning the right of United States & International Securities Corporation to repurchase the preferred stock after its severance from the common stock. The question is posed whether these repurchases of the preferred stock in 1931 and thereafter, up to 1935, did not constitute a deviation from the law as to repurchases of the State of Maryland in which United States & International Securities Corporation had been incorporated.

Chapter 480 of the Laws of 1931 (unchanged through 1935) reads in part as follows:

> No such corporation shall purchase any shares of its own stock unless the assets of the corporation remaining immediately after such purchase shall be not less than the debt of the corporation plus the amount of its issued capital stock, * * *.

By December 21, 1929, the stated capital of the first preferred stock was impaired. The common stock and the second preferred stock had no asset value, and the first preferred stock was "under water."[207] Thereafter, until 1935, the assets of the investment company were not only less than the amount of its total issued capital stock, but less than the stated capital of the first preferred stock alone.[208]

The clearly expressed intent of the Maryland Statute was to safeguard at least the stated capital of a corporation from being disbursed by repurchases of its own stock. In this instance, the investment company throughout a 4-year period, while its assets were inadequate to meet its capital liabilities, used approximately $11,000,000 of the assets belonging wholly to the first preferred stock to

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[207] Reply to the Commission's questionnaire for United States & International Securities Corporation; and op. cit. supra, note 206, at 11944.

[208] See average yearly asset values on p. 1759; also, the semiannual reports of the company in the reply to the Commission's questionnaire, Pt. I.

retire the holders of almost one-half of the first preferred stock at discounts with a substantial asset loss to the retiring preferred stockholders.

The opportunity of a management of a multiple-security investment company to shift asset values between the different classes of securities and to favor its own shareholdings is illustrated in this instance.

The second preferred stock was held exclusively by the sponsor, United States & Foreign Securities Corporation. The repurchases of first preferred stock at a cost of approximately 5½ million dollars in 1930 were at the average price of $63.60 per share. During that year the first preferred stock, on an average basis, was not "under water," [209] while the second preferred stock had very little or no asset value during the year.[210] Hence the $36.40 per share which was relinquished by the retiring first preferred stockholders redounded to the increase in the asset value of the second preferred stock. Repurchases, even at a time when the first preferred stock, itself, was "under water" and the second preferred stock consequently had a "negative" asset value, aided the second preferred stock. Under the latter circumstances, each repurchase of first preferred stock at a discount below asset value had the effect of reducing the deficit in coverage of the first preferred stock and accelerating the time when the second preferred stock, held by the sponsor, would have a positive asset value. Thus, during 1935 the second preferred stock attained a positive asset value ($18.91 per share on December 31, 1935) and the 100,000 shares held by the management then had an asset value of approximately $2,000,000. Had the management not repurchased about half the amount of first preferred stock at an asset loss to the retiring first preferred stockholders, the second preferred stock at this time would still have had no asset value whatsoever.

Another objective may be fairly imputed to the management in embarking upon the repurchases in 1930. The "calls" for the third and fourth final installments upon the allotment certificates were made on March 1 and June 2, 1930, respectively.[211] It was natural in view of the generally adverse conditions in the securities markets and with the market price of the first preferred stock down to about $60 per share in February 1930, that there should be some reluctance on the part of subscribers to make the additional payments on the allotment certificates.

The first preferred stock and allotment certificates had been listed upon the Boston Stock Exchange at the time of distribution, and on December 11, 1929, the first preferred stock and the common stock were listed upon the New York Curb Exchange, although only about 71,000 first preferred shares and a like number of common shares were severed and available for trading.[212]

The first preferred stock was quoted on the New York Curb Exchange in February 1930 at $60¼, climbed to a high for the year of $75 on March 1, 1930, the date of the third "call." This gain of approximately 15 points was recorded in a reported volume of trading

[209] See p. 1759.

[210] Op. cit. supra, note 207.

[211] Op. cit. supra, note 204, Pt. I, Item 16.

[212] Id., Pt. V, Table 12; and derived from supplementary information supplied the Commission for United States & International Securities Corporation.

of only 9,700 shares of first preferred stock.[213] Similarly, the common stock which sold at 2⅝ a share in January 1930 reached a high of $8 a share in April 1930 on a reported volume of only 5,300 shares. It is significant that although the trading in the severed preferred stock and common stock was small, 55,890 allotment certificates were purchased by United States & Foreign Securities Corporation (and subsequently reacquired by United States & International Securities Corporation) in the same first quarter of 1930.[214] The strong support given to the allotment certificates may have contributed to the rise in the market price of the preferred and common stock during the first part of 1930.

Moreover, this temporary rise in the market position of the first preferred and the common stock comprising the allotment certificates, and the activity of the company in the allotment certificates themselves may have influenced the public to pay in the current "calls" for the last two installments on the allotment certificates.

Were the primary motive of the sponsors reduction of capital in the face of the declining market, they could have omitted the final "calls" and declared the allotment certificates paid off on the basis of the proportion already paid in. The procedure of the sponsors in respect to the "calls" and the repurchases seems to have been of an inconsistent character. On the one hand, they elicited new senior capital by promoting the payment of "calls" on the allotment certificates;[215] on the other hand, they reduced senior capital by the repurchase and retirement of preferred stock. Both practices, however, redounded to the advantage of the junior capital owned largely by the sponsors.[216] The repurchases of the preferred stock at a discount, as noted above, improved the asset position of the junior capital; the addition of new senior capital increased the "leverage" for the junior capital and improved the chances for the recovery of the investment which United States & Foreign Securities Corporation had put into the "equity" stocks of United States & International Securities Corporation.[217]

b. Use of Company's Assets to Repurchase Its Preferred Stock at a Premium to Avert Conversion into the Common Stock

Instances, such as those described above, of investment companies paying less to holders of their preferred stock than the current asset value of that stock, thus retiring preferred stockholders at a loss and shifting asset values to the common stock, were frequent. That the converse situation—the payment to a substantial number of preferred stockholders of more than the asset value or call price of their stock with resulting dilution of the asset value of the common stock—should be very rare is to be expected. With the personal interest of the "management" so largely identified with the common stock and the "senior securities" largely in the hands of the public, it is natural that the management should refrain from favoring the preferred stock at the expense of the asset value of the common.

[213] *Commercial and Financial Chronicle.*

[214] Op. cit. supra, note 204, Pt. VII, Table 32.

[215] $611,825, which was paid in on allotment certificates, was forfeited by reason of the fact that they were not fully paid off (op. cit. supra, note 204, Pt. II, Exhibit A, Schedule 18).

[216] The second preferred stock owned exclusively by the sponsors—and the common stock of which approximately 80% was held by the sponsor interests.

[217] Public Examination, United States & Foreign Securities Corporation, at 11945.

It should be noted, however, that a sponsor who holds a substantial portion of the common stock may, under special circumstances, be more vitally interested in maintaining the market price for the common stock than its precise asset value. In this situation he might be willing to repurchase the preferred stock at high prices and to have the common stock suffer from dilution in asset value in order to prevent possible interference with rising market prices in the common.

(1) CENTRAL STATES ELECTRIC CORPORATION

One episode of this character is illustrated in the case of Central States Electric Corporation.[218] The payment of the premium over asset value to preferred stockholders involved disbursement of the company's funds with a reduction of "coverage" for those senior security holders who did not surrender their holdings. The transaction discloses also the concern of a management with the market price of one class of stock, primarily held by the management, rather than exclusive concentration upon an increase of the assets of the company itself.

It will be recalled[219] that Central States Electric Corporation, organized by Harrison Williams in May 1912,[220] had a multiple-security capital structure with senior securities largely in the hands of the public and the common stock closely held by the sponsor.[221] Among its outstanding senior securities[222] were two issues of preferred stock[223] convertible into common stock[224] at the option of the holder within 25 days after notice of a call, the company having reserved the right to redeem each issue at $110 per share.[225]

Due to the convertible features of the 1928 and 1929 series of preferred stocks, a rise in the market value of the common stock would naturally be attended by a comparable rise in the price of the convertible preferred stock. The latter stock would thus automatically seek to attain the market level of the common stock that could be obtained for it upon a conversion.

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[218] For a more detailed discussion of the repurchases of this company, see Ch. III, pp. 960–65.

[219] See supra, pp. 1683–1707.

[220] Public Examination, Central States Electric Corporation, at 12256.

[221] Id., at 12260–79 and 12288–9.

The following tabulation reflects the magnitude of Harrison Williams' holdings in the common stock of Central States Electric Corporation at this time:

	Central States Electric Corporation common shares outstanding	Owned by Harrison Williams	Percent
Dec. 31, 1927	1,090,380	1,055,985	96.0
Dec. 31, 1928	1,177,503	1,142,810	97.1
1929 (Jan.–Nov.)	[a] 8,723,368	7,107,422	81.5

[a] This represents the total outstanding after 100% and 200% common-stock dividends in 1929 (op. cit. supra, note 220. Commission's Exhibit No. 1205). In July 1929, Harrison Williams held 90% of Central States Electric Corporation common (id., at 12315).

[222] For a more detailed discussion of Central States capital structure, see supra, pp. 1683–1707.

[223] Viz, Central States Electric Corporation "Convertible Preferred Stock, Optional Dividend Series," and "Convertible Preferred Stock, Optional Dividend Series of 1929."

[224] For basis of conversion see infra, note 239.

[225] Op. cit. supra, note 220, Commission's Exhibits Nos. 1228 and 1235.

The common stock of Central States Electric Corporation, into which these preferred issues were convertible, had experienced sharp rises in market value during 1928 and the first three quarters of 1929. While several factors, and in particular the various activities in the underlying securities of the investment company [226] contributed to these extraordinary price rises, an important element was Mr. Williams' market activity in the relatively small floating supply of this common stock which was available for trading.[227] Chart 10 compares these price rises with this activity of Harrison Williams over the period. As has previously been discussed,[228] Mr. Williams began his operations in this stock early in 1928. During 1929 Mr. Williams continued his activity in this stock through his wholly-owned company, North American Securities Company (at times referred to as Nasco), employing the technique of making heavy purchases on the stock exchange and redistributing substantially all of this stock off the market through distribution agencies arranged for this purpose. As the total volume of trading increased on the market, Mr. Williams accordingly increased his purchases and redistributions. Sharp market rises in the comon stock coincided with these operations of Mr. Williams,[229] particularly in June, July, and August of 1929, at which time he was most active in the stock.[230]

With these preferred issues selling at prices below the market value of the common stock obtainable by conversion there was an inducement to investors to convert their preferred shares into common stock, which would substantially increase the hitherto limited floating supply of common stock available for trading.[231] Also, arbitrageurs apparently bought this preferred stock below its conversion value and sold the common stock short. After selling the common short, they were able to cover with common shares obtained by converting the preferred shares which had been bought at prices below the conversion value. In this connection Mr. Williams testified as follows: [232]

Q. Let us see what would happen. They would buy the preferred and sell the common short?

A. Yes; then they would convert and get the common to make delivery.

* * * * * * *

Q. If the preferred stock was out of line with the conversion rights, the effect of it would be that the arbitrageurs would buy the preferred stock and sell the common short, is that right?

A. Right.

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[226] Such as various trading accounts in the common stock of The North American Company and in the securities of other investment companies in the system held in the portfolio of Central States Electric Corporation (id., at 12322–7, 12334–6, 12540–1, 13054–60, and Commission's Exhibit No. 1210). For a list of these trading accounts with discussion of their effect see supra, pp. 1683–1707.

[227] Not more than 5% of the common stock of Central States Electric Corporation was in the hands of the public in 1928 and not more than 10% through July 1929. See supra, note 221.

[228] See supra, pp. 1683–1707.

[229] Op. cit. supra, note 220, at 13124–7, 13344, and 13346.

[230] For schedule of daily purchases and sales over these three months see id., Commission's Exhibit No. 1334.

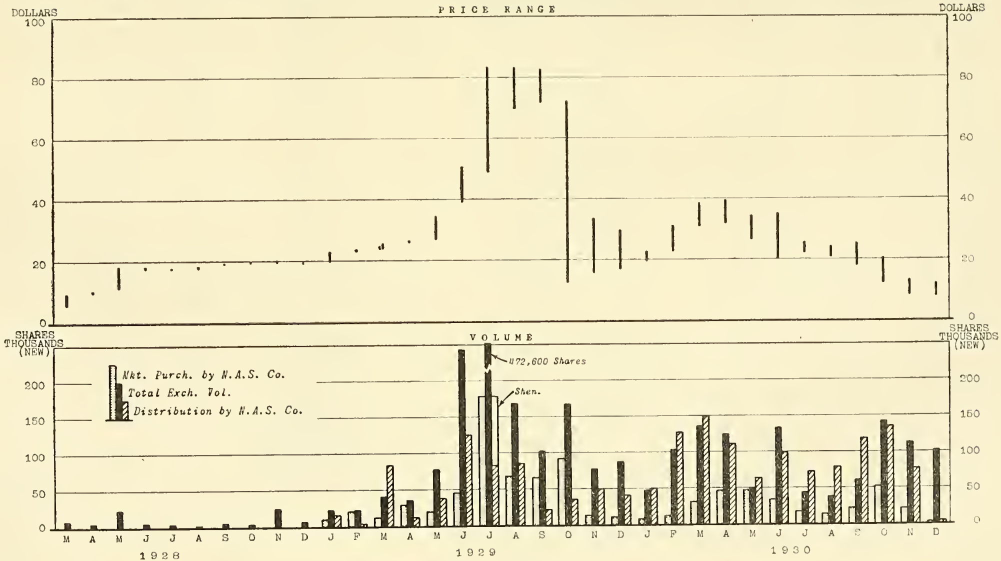
[231] See infra, Chart 11, p. 1768, for comparison of price movements of Central States common and convertible preferred issues.

[232] Op. cit. supra, note 220, at 1323–5. See also testimony by Mr. Johnson, id., at 13173–4.

CHART 10

TRADING AND DISTRIBUTION ACTIVITY IN C. S. E. COMMON

NEW YORK CURB EXCHANGE



Source: Public Examination, Central States Electric Corporation, Commission's Exhibit No. 1252.

The material effect of conversions under these circumstances was to depress the price of the common stock of Central States in which Mr. Williams was substantially interested at the time.[233]

While a call by Central States of these preferred issues at the redemption price of $110 per share might have halted the operations of arbitrageurs, yet a depressing influence would have been exerted upon the market price of the common stock by reason of the large new free floating supply which would have been made available for trading on the market from conversions on a wide scale following such a call. Mr. Williams admitted[234] that a call for redemption would have precipitated such conversions:

Q. The preferred shares were callable at $110, weren't they?

A. Yes, they were callable at $110. I think it was $110. Mr. Higgins: You don't mean practically that they could have been called at that price.

Q. They could have been called. Whether you could have gotten them in or not, I don't know; but they were callable at $110 per share?

A. Right, subject to the conversion.

Q. Your point there is what?

A. That they would have been converted. It would have forced conversion.

To avoid this effect some other means was required for removing the speculative attractiveness of arbitrage operations. To this end it became important to strike a parity between the price of the common stock and that of the preferred stock.[235]

Accordingly, early in 1929, Central States Electric Corporation entered upon a program of repurchasing its two issues of convertible preferred stock primarily in order to prevent the exercise of the conversion privilege. Table 32 reveals the gross and net repurchases of each of these issues.[236]

TABLE 32.—*Repurchases of preferred stocks by Central States Electric Corporation, 1929*

	Approximate volume of market transactions (shares)	Total shares repurchased	Aggregate cost of shares repurchased	Average cost per share repurchased	Total shares sold	Proceeds of shares sold	Average sale price per share	Net shares repurchased	Cost of net shares repurchased	Average price per share (net purchases)
1928 series (Feb. 15 to Oct. 18, 1939)	83, 162	48, 380	$10,037,887	$207. 48	25, 633	$6, 143, 454	$239. 67	22, 747	$3, 894, 432	$171. 20
1929 series (June 22 to Oct. 29, 1929)	73, 380	33, 400	5, 840, 203	174. 86	4, 968	679, 209	136. 72	28, 432	5, 160, 994	181. 52
Total		81, 780	15, 878, 090		30, 601	6, 822, 663		51, 179	9, 055, 476	176. 94

[233] See discussion, id., at 13123, et seq.

[234] Id., at 13115–6.

[235] Id., at 13123–5 and 13173–4.

[236] Id., Commission's Exhibits Nos. 1253, 1254, and 1255.

The intensity of this repurchase activity on the part of Central States is indicated by the fact that from February to October 1929, repurchases by the company accounted for almost 60% of the total shares traded on the market in the 1928 issue and for more than 45% of the total shares traded in the 1929 issue over the entire nine-month period. Chart 11 reveals the trading in Central States common stock and its two convertible issues and the close relations of the price movements with such trading.

The prices paid by the investment company in making these repurchases exceeded not only the redemption value of all the preferred repurchased, but also the asset value of that amount of common stock which would have been issued upon conversion of the same number of preferred shares of each series which were actually repurchased. It will be recalled that Central States Electric Corporation repurchased at a cost of $9,055,427 an aggregate net total of 51,179 shares of both issues of its outstanding convertible preferred stock.[237]

This sum exceeded the redemption value ($110 per share) of the same number of preferred shares [238] by the amount of $3,425,737. Had Central States, instead of repurchasing these shares of preferred stock, permitted their conversion into common stock at approximately the dates of repurchase, it would have been required to issue some 104,000 shares of common stock,[239] having an underlying asset value of only approximately $3,800,000.[240]

On the latter basis, the premium paid by Central States amounted to more than $5,000,000. The payment of this premium of more than $5,000,000 was a diminution of the company's assets to that extent [241]

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[237] The shares repurchased amounted to 21% of the entire 1928 series and 25% of the 1929 series (Reply to the Commission's questionnaire for Central States Electric Corporation, Pt. II).

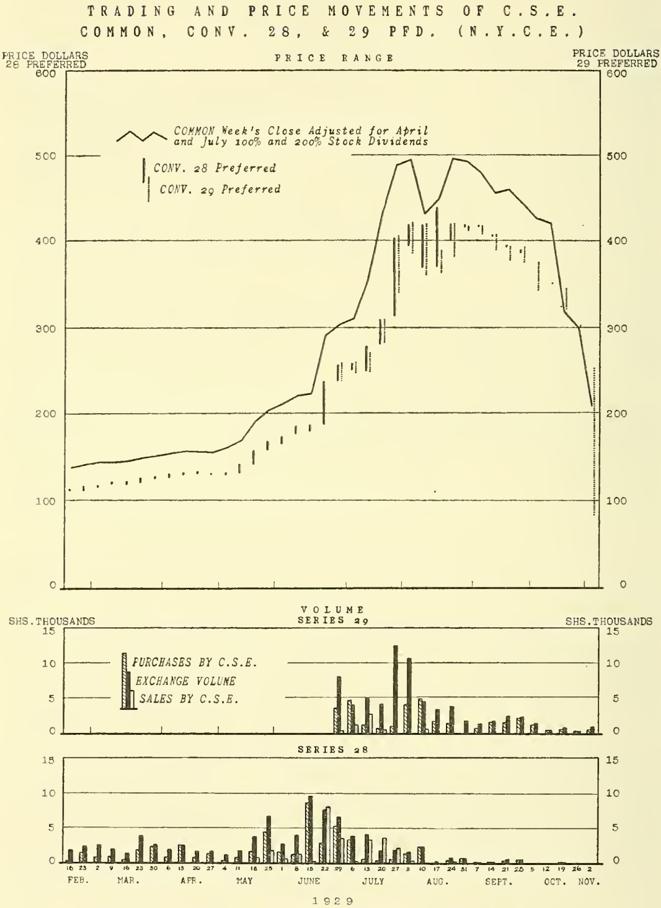
[238] Op. cit. supra, note 220. Commission's Exhibits Nos. 1228 and 1235.

[239] Both issues of Central States convertible preferred stock were originally convertible on the basis of one share of common stock for each $110 in par value of the preferred held. The 100% common stock dividend of April 15, 1929 (*Poor's Public Utility Section* [1929], p. 1694), made the 1928 series convertible on the basis of one share of common for each $59 in par value, at which it remained until the 200% stock dividend of July 15, 1929 (*Poor's Government and Municipal Section* [1930], p. 1088), when this issue became convertible on the basis of one share of common for each $19.67 of its par value. The issue of 1929, though originally convertible on the $118 basis, was expressly provided to become convertible on the basis of one share of common for each $39.33 in par value of this issue after the effective date of the 200% common stock dividend (op. cit. supra, note 220, Commission's Exhibit No. 1235). For daily and monthly repurchases of both issues of convertible preferred stock see id., Commission's Exhibits Nos. 1253 and 1254, respectively.

[240] Computed on the basis of the asset value of the common stock receivable upon conversion at approximately the time of the repurchases and adjusted for special stock dividends on the common stock. (For asset value of the common stock over this period see op. cit. supra, note 220, Commission's Exhibit No. 1206; for total common stock outstanding see id., Commission's Exhibit No. 1329.) The asset value of the common stock used here is the net liquidating asset value, based on Central States Electric Corporation's portfolio securities of affiliated companies taken at asset value and its portfolio securities of other companies at market value (id., Commission's Exhibit No. 1206). If all its portfolio securities be taken at market value, the asset value of the common stock of Central States would be somewhat increased (ibid.).

[241] The expenditure of substantial *premiums over the par value* of the preferred stock repurchased raises the problem as to whether the repurchases as a retirement of capital violated the applicable section of the corporation laws of Virginia (Sec. 3781) which

Chart 11



Source: Public Examination, Central States Electric Corporation, Commission's Exhibit No. 1258.

and naturally a reduction of the cushion for the remaining senior security holders. Because of the particularly broad margin of coverage for the senior securities during the repurchase period,[242] the comparatively small diminution of the cushion appears inconsequential. However, as will appear from a description of the subsequent history of the senior securities of Central States Electric Corporation, not only was the entire cushion eliminated but the preferred stock lost all asset value and the debentures went "under water." [243]

While these repurchases were thus a payment of substantial premiums over liquidating value to those preferred shareholders who sold their stock to the investment company, it is also possible to view these same operations as a repurchase of common stock at prices far above the underlying asset value of that stock. The effect of the direct repurchases of the convertible preferred stock at these premiums was the same as if the company had permitted the conversions to take place with the concomitant issuing of common stock and then proceeded to repurchase that common stock at high premiums above asset value.[244]

The claim was made on behalf of Central States that the repurchase of its issues of convertible preferred stock had as a primary purpose the retirement of capital, despite its doubtful legality.[245] However, in the light of the circumstances under which they were made, it would appear that these repurchases served mainly to protect the high market levels of the common stock of Central States Electric Corporation. Mr. Williams stated [246] that "We were very bullish on that common stock at that time and thought it was going much higher," and indicated that a principal motivating factor for engaging Central States upon its repurchase program was the possible depressing effect that

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provided that reductions of capital could be effected "by the purchase, at the fair market value, *not exceeding par*, of certain shares for retirement or by retiring shares owned by the corporation * * *" (see discussion, op. cit. supra, note 219, at 13176 et seq.) after acquiring the consent of the holders of two-thirds of the voting stock.

For general discussion of the law concerning purchases by a corporation of its own capital stock, see Levy, Irving J., "Purchases by a Corporation of its Own Stock" (15 Minn. L. Rev. 1 (1930)). The author concludes in part that even if the company purchases its own shares out of surplus, yet if such "shares are purchased at a price above the actual value of the shares, the remaining members' shares in the undivided surplus is impaired, and money is actually being taken from the pockets of the remaining members for the benefit of the retiring shareholders" (id., at 26). The author further points out that the purchase by a corporation of its own capital stock is tantamount to a retirement of that stock without compliance with regulatory statutory provisions (id., at 27–31).

[242] For asset coverage of Central States senior securities through 1929, see op. cit. supra, note 220, Commission's Exhibit No. 1329 and reply to the Commission's questionnaire for Central States Electric Corporation, Pt. IV (Item 28).

[243] See supra, pp. 1683–1707, and infra, pp. 1807–19.

[244] While the average price at which Central States Electric Corporation repurchased its convertible preferred stock was $171 in the case of the series of 1928 and $181 in the case of the series of 1929 (op. cit. supra, note 220, Commission's Exhibit No. 1255), the extreme of the premiums paid is indicated by those repurchases, though comparatively small, which were made in late July and early August 1929. At this point in the repurchase program, Central States Electric Corporation was repurchasing as many as 1,000 shares of the series of 1928 at $420 per share and as many as 3,000 shares of the series of 1929 at $210 per share (id., Commission's Exhibit No. 1253).

[245] See supra, note 241.

[246] Op. cit. supra, note 220, at 13119–20.

would have been felt upon the rising market of the common stock from a widespread exercise of the conversion privilege:[247]

Q. By buying this preferred stock, you were preventing the further issuance of common stock.

A. We were preventing additional common being put out to that extent.

Another important factor militates against the contention that these repurchases by Central States had as their primary objective the retirement of capital. There were outstanding over the repurchase period two issues of nonconvertible preferred of Central States Electric Corporation (7% and 6%) which could have been repurchased for retirement much more cheaply than the cost to the company of its repurchases of the convertible preferred. This nonconvertible preferred sold as low as $115 and $81, respectively, during the repurchase period[248] while an average of $171 and $181, respectively, was expended per share for the repurchase of the convertible preferred of 1928 and 1929.[249] Notwithstanding that this nonconvertible preferred could have been repurchased for retirement much more cheaply, Central States Electric Corporation purchased only 263 shares of the 7% nonconvertible preferred at a total cost of $30,245 and only 6,260 shares of the 6% nonconvertible preferred at a total cost of $520,796.[250] The 6% nonconvertible preferred stock was itself redeemable at any time in whole or in part at $110.[251] Thus, this entire issue could have been reacquired at a cost to the company of no more than $110 per share.[252]

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[247] Id., at 13127 and 13131. This testimony was corroborated by Christian Johnson, an employee of Mr. Williams (id., at 13149):

Q. Therefore, all you did by refusing to call the preferred stock was to save your common stock by conversion?
A. That is correct.

It was also corroborated by Louis E. Kilmarx, vice president of Central States (id., at 13160–1):

Q. Then, at that time, it was not for the retirement of the preferred stock, but to prevent the conversion.
A. With both purposes in mind, for retirement and to prevent conversion which, in substance, is for retirement, when you prevent the conversion.
Q. I still don't understand. If you are interested in retiring your preferred stock, I cannot understand why you didn't retire the other preferred stock which was selling at a discount.
A. The question of retiring that didn't come up. That was a 6-percent stock with no conversion rights. So the second purpose was to prevent conversion and not issue any more common stock.

* * * * * * *

Q. * * * Now, to come back, isn't it a fact that what you are saying is the only purpose for retiring this stock is to prevent conversion?
A. That was the primary purpose, yes.

[248] Op. cit. supra, note 220, Commission's Exhibit No. 1253.

[249] Id., Commission's Exhibit No. 1255.

[250] Id., Commission's Exhibit No. 1253.

[251] Reply to the Commission's questionnaire for Central States Electric Corporation, Pt. V.

[252] The convertible preferred issues could have been just as effectively reacquired for retirement by means not involving the expenditure of any cash by the company. Central States Electric Corporation could have called this convertible preferred stock at $110, allowed the conversions and could have issued common stock at no cost to itself. (See discussion in op. cit. supra, note 220, at 13116–32.) In this way the senior capital would have been retired with absolutely no outlay of cash on the part of the company instead of the large premiums actually expended.

A number of other factors weaken the contention as to retirement of capital. For example, a $10,000,000 issue of convertible preferred stock was publicly offered in June 1929 (id., Commission's Exhibit No. 1235) in the midst of the repurchase program. Also Mr. Williams stated that Central States was in need of cash at the time for further utility investments (id., at 13051–3). He further stated that, by repurchasing the convertible issue of 1928 and offering the series of 1929, likewise convertible but upon a lesser basis,

Apparently Mr. Williams experienced some doubt or misgivings as to the use made of the funds of Central States Electric Corporation in repurchasing its preferred stock to support the market for its common stock in which Mr. Williams was so largely interested.[253] In December 1929, subsequent to the repurchase activity, but prior to the retirement of the repurchased preferred stock, through his wholly owned New Empire Corporation,[254] he made a donation to Central States Electric Corporation of 1,718,995 shares of its own common stock.[255] Apparently recognizing the possibility of liability, he attached the following condition to this donation to Central States.[256]

that, to the extent necessary, you will accept the benefits resulting to you from our contribution * * * to reimburse you for any loss which you have incurred or may incur by reason of the purchase by you of the 22,767 shares of your Optional Dividend Preferred Stock, Series of 1928 and of 28,432 shares of your Optional Dividend Preferred Stock, Series of 1929, heretofore acquired by you and now held in your treasury, and that, to the extent necessary, you will apply the addition to your capital surplus resulting from our contribution of these shares to offset any such loss on your part.

c. Nullification by the Management of the Liquidation and Redemption Rights of Fully Covered Senior Securities by Refusal to "Call" or Repurchase While Held in Some Hands but Repurchasing After Affiliated Interests Had Acquired the Stock at a Discount

It has been previously observed that the practice of repurchase of their own preferred stocks at discounts by investment companies enables "managements" to shift the assets from the retiring stockholders to the common shareholders. This situation exists even when the repurchases are made in the open market and when there is no discrimination by the management between prospective sellers of preferred stock. The problem is, of course, aggravated when "management," entrenched by virtue of a "junior" shareholding utilizes the company's funds to make private repurchases of senior securities from "insiders." The management is in a position to decline to "call" the preferred stock for redemption even if assets are more than sufficient to cover the stipulated "call" price of the stock or refuse to repurchase at any price as long as the stock is in the hands of an "outsider." When, however, the preferred stock has found its way into the hands of an "insider" at a low price, induced perhaps by mistrust of the "management" and the latter's refusal to "call"

the conversion rights outstanding were thereby reduced, indicating that the conversion factor was a most important consideration (id., at 13140–1. See also id., at 13152–5). Finally, Central States reissued at a profit a number of the shares repurchased as their market price rose (id., at 13154–5, and 13166; see also supra, p. 1764).

[253] It was admitted that the policy of embarking Central States Electric Corporation upon this repurchase program was arrived at by Harrison Williams (op. cit. supra, note 220, at 13158). There was no official authorization by the board for these repurchases. Harrison Williams testified that "* * * it was informally understood, but no official act. The directors knew without a matter of record just what was being done" (id., at 13176).

[254] Op. cit. supra, note 220, Commission's Exhibit No. 1207.

[255] Id., at 13242–71, 13295–306, 13359–67, and Commission's Exhibits Nos. 1263 and 1264.

[256] See letter under date of December 6, 1929, from New Empire Corporation to Central States Electric Corporation (id., Commission's Exhibit No. 1263).

or repurchase, the "management" can then proceed to repurchase from the "insider" at a price substantially higher than that paid by this "insider." The result of such tactics is that the public senior security holder has taken a severe loss in asset value and the equivalent value has not even gone into the treasury of the company but has been turned over to a private affiliation of the "management." The repurchases made by General Investment Corporation of its own preferred stock from Wallace Groves were of this character.

(1) GENERAL INVESTMENT CORPORATION

General Investment Corporation had been organized as an investment and holding company under the name of The Public Utility Holding Corporation of America in Delaware in September 1929, by Harris, Forbes & Company, a New York investment banking house, and United Founders Corporation, a group of investment companies in which Harris, Forbes & Company had acquired a strong position as underwriter, distributor, and part of the management.[257]

Active management of The Public Utility Holding Corporation rested in the hands of Harris, Forbes & Company until July 1933, when United Founders Corporation took over the active management, changing the name of the company to General Investment Corporation.[258]

From November 1933 to August 1936, under the management of United Founders Corporation and its successor, American General Corporation, the activities of General Investment Corporation were concerned primarily with the liquidation of its portfolio of utility securities and the use of its funds so derived to reacquire its own preferred stock at a substantial discount from asset values.[259]

During this period George Devendorf, associated with United Founders Corporation and American General Corporation, served as a vice president of the General Investment Corporation from the inception and as its president from June 1932 until August 3, 1936.[260]

In August 1936, Ernest Warriner, who from 1931 had been associated with Wallace Groves in the latter's investment company activities,[261] negotiated a contract by which he undertook to purchase from American General Corporation the controlling interest held by that corporation in General Investment Corporation.[262] Mr. Warriner assigned this contract to International Equities Corporation, an investment company which he had acquired some months previously,[263] which made the down payment of $300,000 specified in the contract so that Mr. Warriner acquired control of General Investment Corporation without the expenditure of any of his personal funds. Although the "control" stock of General Investment Corporation was to be held as collateral by American General Corporation

[257] For a detailed exposition of the history of General Investment Corporation, see Ch. II of this part of the report, pp. 497–623; Public Examination, American General Corporation et al., at 25409, 26320, 26322, 22100, and Commission's Exhibit No. 3423 (p. 1).

[258] Public Examination, American General Corporation, at 23109, 23144–9, 25292–6, and Commission's Exhibit No. X–3424 (p. 16).

[259] Id., Commission's Exhibit No. X–4129.

[260] Id., Commission's Exhibit No. X–3424 (p. 16).

[261] Id., at 20310–1.

[262] Public Examination, General Investment Corporation, Commission's Exhibit No. 1577.

[263] Id., Commission's Exhibit No. 1565

until completion of the contractual payments, Mr. Warriner was given the power to vote that stock immediately.[264] He had himself and his associates elected as officers and directors of General Investment Corporation. All of the representatives of American General Corporation in the directorate and in office, including George Devendorf, resigned.

It should be noted that these rapid transfers of control were facilitated by the fact that General Investment Corporation had a multiple-security structure. The corporation had a preferred stock, a Class A common stock, and a common stock. At the time of transfer of control to Mr. Warriner, American General Corporation controlled the investment company through ownership of all its Class A stock which gave American General Corporation 50% of the voting power, although that represented only a 22% interest in the assets, the predominant proprietary interest resting in the hands of the public.[265] This controlling shareholding American General Corporation transferred to Mr. Warriner.

General Investment Corporation, when Mr. Warriner took over control, had outstanding approximately 58,000 shares of $6 cumulative stock, which were entitled to $115 each on liquidation and could be redeemed by the company on payment of $115 per share. Despite the fact that the company had, from the time of its inception to the end of 1936, lost $68,000,000 of the $78,000,000 invested therein, each share of the outstanding preferred stock had an actual liquidating asset value of approximately $150 per share.[266] The preferred stock had priority claims for principal liquidating amount and accumulated dividends totaling approximately $150. The assets of the company were sufficient to meet these claims.

George Devendorf, at the time of his resignation as president of General Investment Corporation, held some 9,000 to 10,000 shares of the preferred stock of the company.[267] Upon being refused continuation of a place on the board of directors to represent stockholders who held the minority of the voting power, of which he was one, he requested that Mr. Warriner cause the corporation to repurchase his preferred stockholdings.[268]

Although the asset liquidating value of the preferred stock at this time was approximately $150, Mr. Devendorf, distrustful of the new management, was ready to accept much less than the stock was worth.[269] Mr. Warriner informed Mr. Devendorf that he (Mr. Warriner) was unwilling to devote any of the funds of General Investment Corporation to the repurchase of its preferred stock.[270] In fact,

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[264] Ibid.

[265] Id., at 15162 and 15165.

[266] Id., at 15053–4 and 15181–2; see also *Moody's Manual of Investment, Banks, etc.*, 1937, p. 1743.

[267] Op. cit. supra, note 262, at 15184.

[268] Id., at 15181–2.

> Q. So the situation was that here you were, the largest single stockholder in that corporation, exclusive of the "A" stock, absolutely impotent to do anything under the circumstances.
> A. I couldn't even find out what was going on in the corporation.
> Q. You spoke to Mr. Warriner?
> A. Yes, sir. And I spoke to other directors as well.

[269] Id., at 15181–2.

[270] Id., at 15180.

Mr. Warriner, according to Mr. Devendorf's testimony, stated that there would be no retirement nor repurchase and that the preferred stockholders need not fear any reorganization which would cut off accumulations of dividends on the preferred stock.[271]

Very shortly after the categorical refusal of Mr. Warriner to have the company expend its funds for the repurchase of its stock of Mr. Devendorf, Mr. Warriner aided Wallace Groves in acquiring the preferred stock held by Mr. Devendorf and other preferred stockholders at a price of $87.50 and then had the company repurchase this stock from Mr. Groves at $102 per share.

In November 1936 Mr. Warriner introduced Mr. Devendorf to Wallace Groves as "an unhappy stockholder" desirous of selling his preferred stock.[272] In December 1936 Mr. Groves, after some negotiation, agreed to purchase through his personally owned holding company, Nassau Securities Company, Ltd., organized under the laws of the Bahamas, no less than 17,500 shares of the preferred stock of General Investment Corporation at $87.50 per share.[273] The terms of Mr. Groves' offer required that the shares to be purchased, a minimum of 17,500, be deposited by January 21, 1937, at The Royal Bank of Canada in Montreal, payment to be made to the depositing stockholder on January 25, 1937, at this bank.

On January 8, 1937, Mr. Devendorf sent the copy of Mr. Groves' offer to all of the stockholders of the General Investment Corporation,[274] the names and addresses of which he procured from Mr. Warriner.[275] Although fully aware that Mr. Groves was engaged in gathering in preferred stock from other stockholders at $87.50 per share, Mr. Warriner gave no indication of any intention that, or any possibility that, the company might repurchase or retire any of its preferred stock to the preferred stockholders whom Mr. Groves solicited, nor did he advise them that the actual liquidating value of their stock was $150 per share as compared with the price of $87.50 offered by Mr. Groves.[276] Yet at the very time that Mr. Groves was gathering in the preferred stock Mr. Warriner was engaged in arranging the prospective repurchase by the company from Mr. Groves at a price of $102 per share and, moreover, was apparently maneuvering the details in such manner that Mr. Groves should have the General Investment Corporation's money before the date set for the payment by Mr. Groves for the preferred stock which he was buying and reselling to the investment company.

Between January 18 and January 22, 1937, Mr. Warriner separately requested each of the members of the board of directors of General Investment Corporation to approve a proposed purchase by the company of its preferred stock from Wallace Groves at $102 a share. Mr. Warriner stated to the members of the directorate that he was impelled to buy such stock from Wallace Groves because, as Harlan J. Wright, one of the directors testified, "it would be embarrassing, and, as he (Warriner) felt, he could not afford to have Mr. Groves

[271] Id., at 15180–1.
[272] Public Examination, American General Corporation, at 20224.
[273] Id., at 20293, and Commission's Exhibit No. 1569.
[274] Op. cit. supra, note 262, Commission's Exhibit No. 1569.
[275] Id., at 15175–6.
[276] Op. cit. supra, note 272, at 20655.

an owner of a large share of that stock." [277] The directors of General Investment Corporation approved, on January 22, 1937, the purchase by General Investment Corporation from Nassau Securities Company, Ltd., of an amount not exceeding 27,000 shares of the preferred stock of General Investment Corporation at $102 per share.[278]

On January 23, 1937, two days after the preferred stock was to have been deposited at The Royal Bank of Canada, pursuant to the offer of Wallace Groves, and two days prior to the date on which Wallace Groves was required to pay for the preferred stock so deposited, Mr. Warriner went to Montreal and consummated a contract with the Nassau Securities Company, Ltd., the personal company of Wallace Groves, whereby General Investment Corporation undertook to purchase, on January 23, 1937, 24,591 shares of the preferred stock of General Investment Corporation at $102 a share,[279] which was the amount of such preferred stock actually deposited with The Royal Bank of Canada on January 21, 1937, pursuant to the offer of Nassau Securities Company, Ltd., to purchase such stock at $87.50 per share. On January 23, 1937, General Investment Corporation paid $102 per share for 20,731 of these shares,[280] and on January 25, 1937, Wallace Groves, with a portion of the funds so derived by him, in turn paid $87.50 per share for these shares.[281] As a result, Wallace Groves made a net profit of $300,000 on the 20,731 shares which General Investment Corporation had purchased on January 23, 1937, at $102 per share, and for which Wallace Groves himself thereafter made payment on January 25 at $87.50 per share.[282]

Through the possession of the voting power of the Class A common stock, disproportionate to the contribution of that class of common stock to the capital of the company, Mr. Warriner was in a position to refuse to repurchase preferred stock at a lower price when held by an "outsider" and consummate a repurchase of the same stock at a higher price when held by an "insider," was able to facilitate the retirement of preferred stockholders at a great loss in asset value to the latter, and succeeded in diverting the major part of the profit, which the company might have made through the repurchase at a discount, from the company to a privately affiliated individual; and the entire transaction was accomplished through the use of the company's funds.

4. IMPAIRMENT OF PREFERRED STOCKHOLDERS' POSITION THROUGH THE CONTRACTING OF BANK INDEBTEDNESS WHICH CONSTITUTES A PRIOR LIEN ON THE ASSETS OF THE COMPANY

Many issues of preferred stock of investment companies have undoubtedly been distributed on the strength of the fact that they constituted at the time of issuance a senior claim on the assets of the company; i. e., that there were no bonds or other indebtedness out-

[277] Id., at 20624–7.

[278] Op. cit. supra, note 262, at 15203, and Commission's Exhibit No. 1571.

[279] Id., Commission's Exhibit No. 1571.

[280] Id., Commission's Exhibit No. 1575.

[281] Id., at 15188–9, 15208; op. cit. supra, note 272, at 20625–6.

[282] Op. cit. supra, note 272, at 20525.

standing having a claim to the assets superior to the preferred stocks. The safety of issues of preferred stock which are not protected by provisions that no bonds or additional preferred stock having a prior or coordinate claim may be issued without the consent of the existing preferred stockholder is almost completely in the control of a common stock management. The insecurity of a preferred stock issue of an investment company not so protected will be discussed hereinafter. But even if a common stock management is restrained from subordinating a preferred stock issue to subsequent issues of stock, it may yet be in a position to effect a subordination of the preferred stock to general or secured creditors and thus deprive the preferred stock of first access to the assets of the company.[283] This situation the common stock control may accomplish by the expansion of current liabilities—possibly to facilitate the effectuation of plans that are intended to benefit the control group or are aimed at rescuing the management from crises brought on by its own mismanagement.

One of the most common forms of the imposition of creditor risks upon the preferred stock is the practice of bank borrowing on the part of the investment company, entailing, as it frequently does, the hypothecation by the company of its soundest and most readily marketable securities. The right to priority in the distribution of the assets of the company originally granted the preferred stock has thus been encumbered by the claims of a creditor, and the principal assets of the company have been contingently alienated from the preferred stockholder.

a. The Equity Corporation Bank Loans

The power of the common stock control to interpose the supervening claim of a creditor between the assets of the company and the preferred stockholders of the company to whom the assets at the time equitably belong is illustrated by the manner in which The Equity Corporation hypothecated its entire portfolio,[284] including the stock to be purchased with the proceeds of the loans, to secure loans from a

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[283] "The strength of the preferred stockholder's original claim on the assets of a corporation is not in the least safeguarded in a great number of cases. The directors have authority to issue notes and create a large floating debt taking precedence over the preferred shares. The notes may bring the company to a receivership, but the preferred stockholders cannot intervene. In the final reorganization they find themselves passive spectators to the disintegration of their property and the dissipation of assets in which they originally had either a first lien or a valuable equity. But the harm to the preferred stockholders may not be as overwhelming as that resulting from a forced reorganization, and yet represent a very serious, although perhaps unnoted, emasculation of the original value of their shares. Many preferred stocks are sold with the understanding that no bonds nor notes exist ahead of them. The bond salesman may even stress this point in an effort to make the preferred shares appear as secure as bonds to the cautious investor. It is probably true at the time of issue that the preferred stock, subject only to a small current debt, has the first claim to the property, but as soon as the corporation encounters the slightest difficulty, or a sudden demand for new money, or feels the insidious influence of a management which cannot measure size by strength, it turns to the issue of bonds or notes as the easiest method of getting money. During the depression years of 1920 and 1921, and of 1932 and 1933, many corporations whose credit was very high, because they had been financed only by the sale of preferred shares, turned to the issue of notes on a 7, 8, or even 9% basis. In other words, the preferred shareholders, whose liberal purchase of stock had made the credit of the corporation secure, were sacrificed at the first emergency. And the possible increase of earnings due to the war expansion would not, in any way, benefit the preferred shareholders whose credit position had been ruthlessly sacrificed." Dewing, A. S., *Corporate Securities* (1934), pp. 185–6.

[284] Public Examination, The Equity Corporation, Commission's Exhibit No. 788.

bank in order to acquire Reliance International Corporation, another investment company.

The Equity Corporation, in connection with its acquisition of control of Reliance International Corporation, purchased from Atlas Corporation, on December 7, 1934, 275,194 shares of Class A and 38,288 shares of the preferred stock of Reliance International Corporation for $1,912,922 in cash, and borrowed the sum of $2,280,000 for this purpose.[285]

The Equity Corporation, when it made these loans, was not in a liquid position, for it had but $10,731.94 in cash on hand and only $54,780 in securities other than that of controlled and associated investment companies.[286] Its assets consisted practically exclusively of the large blocks of stock of such controlled and associated companies.[287] Of The Equity Corporation's total assets, stated at $8,862,012.98 in the balance sheet for December 31, 1934, $8,827,822.61 was described as the "carrying value" of its securities.[288]

In order to raise the loans of $2,280,000, The Equity Corporation, out of total assets evaluated at $8,862,012.98, pledged securities carried on its balance sheet at a value of $8,673,449.13.[289] The Equity Corporation thus mortgaged practically all of its property, including its interest in the controlled and associated companies. It should be noted that in pledging practically all of its gross assets the corporation had hypothecated an amount in excess of its net assets, which totaled only $6,525,781.80 at this time.[290]

Mr. Milton testified how completely The Equity Corporation placed itself in the control of the bank.[291]

Q. * * * so that you hypothecated the entire The Equity Corporation and its interests in all its subsidiaries to raise approximately two and one-quarter million dollars, so that you could buy this investment trust from the Atlas interests, isn't that so?

* * * * * * *

A. Yes, substantially so, but I wish to point out that the loan was amply covered by this collateral, and it would have made very little difference whether we collateralized the loan in a smaller amount, because The Equity Corporation, of course, would have been liable to the full extent of the loan in any event.

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[285] Id., at 8463–4.

[286] Id., Commission's Exhibit No. 772 J 8. These figures are taken from the balance sheet of The Equity Corporation for December 31, 1934; the last of the 3 loans aggregating $2,280,000 was made on December 27, 1934 (id., Commission's Exhibit No. 788). There is no evidence of any substantial change in the balance sheet items or in the net asset position of the company between December 27, 1934, and December 31, 1934, the date of the statement.

[287] Id., Commission's Exhibit No. 788.

[288] Id., Commission's Exhibits Nos. 772 J 8 and 788. The investments in securities of controlled companies were carried at net asset value applicable thereto on the basis of taking securities owned by each company at current quoted market prices or fair value in the opinion of the officers. The investments in associated companies were carried at a cost figure which, in the aggregate, in the opinion of the officers of the company, was not in excess of fair value (id., Commission's Exhibit No. 772 J 8). Since the market value of the securities of the affiliated investment companies was at this time considerably lower than the net asset value of the securities, the "carrying value" used in the balance sheet was approximately three and one-half million dollars above the current market value (id., Commission's Exhibit No. 788).

[289] Id., Commission's Exhibit No. 788.

[290] Id., Commission's Exhibit No. 772 J B; total assets were $8,862,012.98 and liabilities were $2,336,231.18.

[291] Id., at 8465–6.

Q. You didn't give the bank anything they were not asking for, Mr. Milton, were you?

A. We told them that we would give them anything that they would like to have.

Q. And they asked for the whole The Equity Corporation, subsidiaries and all, wasn't that so?

A. I don't remember whether they asked for it, but we put it up, and they got it.

At this time The Equity Corporation had outstanding 111,262 shares of preferred stock [292] entitled to $50 per share on liquidation and to accumulations of unpaid dividends amounting to $328,566.25,[293] thus having claims on liquidation totaling $5,891,666.25. The preferred stock was almost entirely in the hands of the public, while a substantial block of the common stock was owned indirectly by David M. Milton and his associates.[294] Since the net worth of the company was not more than approximately $6,500,000, the "common-stock control" was hypothecating property of the company in which the common stock had only a slight equity and which in effect belonged to the preferred stockholders.[295] This transaction illustrates how the "common-stock control" can diminish the assurance which the preferred stockholder is presumed to receive when he invests in the company. In this case a company having barely enough assets to satisfy the claims of the preferred stock mortgaged all of its assets to obtain a loan, the proceeds of which were employed in the purchase of stock of another investment company, the stock so purchased being included in the securities hypothecated for the loan. As a result, practically the entire property of the company was placed in the hands of the bank, the recovery thereof being rendered contingent upon repayment of the loan. There were no visible assets left in the company from which repayment could reasonably be expected to be made. If in some contingency the bank had been permitted to foreclose on the collateral, dire consequences might have been sustained by the preferred stockholders of The Equity Corporation. It should be recalled that the net assets of the company could be viewed as sufficient to cover the claims of the preferred stock only if the securities of the company were accepted at "carrying value." At current market prices the value of the securities owned by the company aggregated approximately $3,500,000 less than the "carrying value." [296] In the event of a forced liquidation of the

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[292] Id., Commission's Exhibit No. 772 (p. 10).

[293] Ibid. Arrears on the outstanding 111,262 shares of preferred stock were:

$5.25 on 14,628 shares	$77,797.00
$4.50 on 21,845 shares	98,292.50
$3.75 on 2,886 shares	8,822.50
$3.00 on 36,472 shares	109,416.00
$1.50 on 12,860 shares	19,290.00
$0.75 on 19,931 shares	14,948.25
	328,566.25

[294] Op. cit. supra, note 284, at 7849–50, 11983–91, and Commission's Exhibits Nos. 766, 831, and 1173.

[295] According to the December 31, 1934 statement the preferred stock had a coverage of $58.38, while the asset value of the common stock was about $0.14. This, of course, is on the basis of the "carrying value" in the market value of the securities owned by the company. (Id., Commission's Exhibit No. 772 [p. 4].)

[296] Id., Commission's Exhibit No. 788:

Approximate market value of shares pledged	$5,108,626.35
Carrying value of shares pledged	8,673,449.13
Approximate market value of free shares	117,503.74
Carrying value of free shares	154,373.48
Carrying value of shares owned	8,827,822.61
Approximate market value of shares owned	5,226,129.99

hypothecated securities by the bank, the "carrying value" of the securities might not have been realized.

The common stock, on the other hand, having practically no asset value prior to this transaction, had little to lose. The raising of the loan secured the common stock management new funds with which to embark upon the acquisition of another investment company which, if successful, would, through the payment of a consideration less than the value of the assets of the acquired company, increase the asset value and enhance the "leverage" in the common stock of The Equity Corporation.

As a matter of fact, The Equity Corporation expected to and ultimately did pay off the loans from the assets of subsidiaries with which it intended to merge. Mr. Milton testified: [297]

Q. Now, you had this $3,300,000 [298] in loans by The Equity Corporation, that is the top company, and then on March 25, 1935, when you merged the Chain & General, and Interstate Equities Corporation, into The Equity Corporation, you came into some cash, did you not?

A. The merged company naturally was in a liquid position. Generally, as a result of a merger, there was cash, that is right.

Q. And then you used $2,000,000 of that cash to pay off part of the $3,300,000 on the loan, isn't that so?

A. Out of the liquid position, the loan was paid off, is that right? The liquid position of the merged corporation was used to pay off the loan.

Q. That is $2,000,000 of it.

A. That is right.

On September 6, 1935 Reliance International Corporation itself and American, British & Continental Corporation, another subsidiary, were merged with The Equity Corporation. Cash assets of these two corporations were turned over to the bank in final liquidation of the loan.[299]

Had these highly speculative anticipated mergers failed, the consequence to the preferred stockholders of The Equity Corporation can readily be visualized.

5. SUBORDINATION OF PREFERRED STOCK BY ASSUMPTION OF A BOND ISSUE OF A SUBSIDIARY

a. Tri-Continental Corporation

As has been noted above in the account of its repurchase activities,[300] the new Tri-Continental Corporation was the result of a consolidation in December 1929 of the old Tri-Continental Corporation and Tri-Continental Allied Company, Inc. The new company commenced business on January 1, 1930, with net assets of $75,302,000 and a capital stock consisting of 433,650 shares of preferred stock and 2,020,150 shares of common stock.[301] The new company, as well as the two

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[297] Id., at 8499–8500.

[298] The indebtedness of $2,280,000 was subsequently increased to $3,300,000 (id., at 8498).

[299] Id., at 8501–2.

[300] See Ch. III of this part of the report, pp. 966 et seq., and pp. 1009 et seq.

[301] Public Examination, Tri-Continental Corporation, at 18551, and Commission's Exhibit No. 2081, III-A.

consolidated companies, had from the beginning been sponsored by J. & W. Seligman & Co., a firm of investment bankers, brokers, and underwriters.[302]

In a letter to the preferred stockholders, dated December 11, 1929, in which the plan of consolidation was outlined and approved by the board of directors, the capital structure of the consolidated company was represented as providing for "a single issue of preferred stock, a single issue of detached warrants, and a single issue of common stock." [303] In the outline of the plan of consolidation, which was transmitted with that letter under the title of "New Securities" describing the preferred stock, this statement appeared: "The consolidation agreement will contain certain restrictions, similar to those contained in the certificates of incorporation of the constituent corporations, upon the creation and issue of preferred stock ranking prior to or on an equality with this preferred stock and upon the creation of funded debt." [304] In Schedule C which contained extracts from the agreement of consolidation, these "certain restrictions" pertinent to the creation and issue of preferred stock and the creation of funded debt were embodied in Article Eighth, subdivision 6, as follows: [305]

6. The Corporation shall not, without the affirmative vote of at least two-thirds in amount of such of the preferred stock as may be present in person or by proxy and voting at a meeting of the preferred stockholders called for the purpose or the written consent of the holders of at least two-thirds in amount of the prefered stock at the time outstanding, so long as any prefered stock shall be outstanding.

(a) create any shares of stock having preference or priority over the preferred stock;

(b) issue any shares of stock on a parity with the preferred stock, or reissue, sell or in any manner dispose of any of the preferred stock which may have been redeemed or purchased for retirement, unless immediately after the issue, reissue, sale or disposition thereof, the net assets of the Corporation as determined by the board of directors (whose determination in the absence of fraud shall be conclusive) shall be equal to at least two hundred percent (200%) of the aggregate par value of all the shares of the preferred stock, and of all the shares of such stock on a parity with the preferred stock, then outstanding;

(c) issue, assume, or guarantee any bonds, notes, or other evidences of indebtedness, whether secured or unsecured, maturing more than one year from the issue, assumption or guaranty thereof, if immediately after the date of the issue, assumption or guaranty thereof, the aggregate principal amount of all bonds, notes, or other evidences of indebtedness issued, assumed, or guaranteed by the Corporation and maturing more than one year from such date shall exceed one hundred and fifty percent (150%) of the capital and surplus of the Corporation;

(d) amend this agreement of consolidation so as to change or alter the provisions of this Article Eight relating to the preferences, voting powers, restrictions, and qualifications of the preferred stock.

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[302] Reply to the Commission's questionnaire for Tri-Continental Corporation, Pt. VIII (Item 77).

[303] Op. cit. supra, note 301, Commission's Exhibit No. 2081, III-A.

[304] Ibid.

[305] Ibid.

Every prospectus issued by the investment company from September 1930 through July 1931 prominently stated that "the Corporation has no bank debt and no funded debt."[306] This fact was emphasized even though the asset value of the preferred stock during the period of the announcement was well above par. Despite the significance that the management attached to the absence of funded debt, it proceeded thereafter to impose a funded debt upon the investment company, without the prior knowledge, consent, or approval of the preferred stockholders, and at a time when the preferred stock was "under water," by having the investment company assume a debenture issue of Investors Equity Co., Inc., another investment company of which Tri-Continental Corporation was acquiring control. At the time of making his investment in the preferred stock, the investor may have relied upon the capital structure then existing and the information furnished to him by the prospectus. Earle Bailie, partner in J. & W. Seligman & Co. and chairman of the board of directors of Tri-Continental Corporation, readily conceded that these constitute the primary reliance of the investors.[307]

Below are given the asset values of the preferred stock as set forth in the annual and quarterly reports of Tri-Continental Corporation, ending with the report after the acquisition of the assets of Investors Equity Co., Inc., whereby Tri-Continental Corporation for the first time imposed a debenture upon its assets by assumption of the outstanding debentures of the acquired company.[308]

Date:	*Asset value of preferred stock*
December 31, 1930	$150.72
March 31, 1931	160.03
June 30, 1931	143.95
September 30, 1931	119.42
December 31, 1931	100.94
March 31, 1932	97.58
June 30, 1932	69.24

On March 31, 1932, the preferred stock was "under water" for the first time. While this condition existed Tri-Continental Corporation acquired $5,565,000 of the assets of Investors Equity Co., Inc., of which over $5,000,000 represented liquid assets chiefly in the form of cash, United States Government bonds, and short-term securities.[309]

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306 Reply to the Commission's questionnaire for Tri-Continental Corporation, Pt. I.

Exhibit I–9–H, Prospectus, dated September 16, 1930. The asset value of the outstanding preferred stock was $179 per share as of September 10, 1930.

Exhibit I–9–I, Prospectus, dated November 3, 1930. The asset value of the outstanding preferred stock was $166.82 per share as of September 30, 1930.

Exhibit I–9–J, Prospectus, dated May 18, 1931. The asset value of preferred as of March 31, 1931, was $160.03. This prospectus revealed that the assets of Wedgwood Investing Corporation were acquired by an exchange of stock, which will be discussed later.

Exhibit I–9–K, Prospectus, dated July 1931. The asset value of the preferred stock was $143.95 per share as of June 30, 1931.

307 Public Examination, Tri-Continental Corporation, at 18687.

308 Op. cit. supra, note 302, Exhibits I–8–D, I–8–E, I–8–F, I–8–H, I–8–J, I–8–L, and I–8–M.

309 Derived from supplementary information supplied the Commission for Tri-Continental Corporation (Item 8) and Public Examination, Tri-Continental Corporation, at 18579

Investors Equity Co, Inc. was an investment company organized in Delaware. On April 20, 1932, its board of directors agreed to the sale of the assets to Tri-Continental Corporation. On May 18, 1932, the stockholders of Investors Equity Co., Inc., at a special meeting called for that purpose, approved the sale and voted to dissolve the investment company. A bill of sale was signed on the same day. To acquire the assets of Investors Equity Co., Inc., Tri-Continental Corporation assumed $2,835,300, Series A, 5% Debentures due June 1, 1947, and $2,293,600, Series B, 5% Debentures due April 1, 1948, with warrants, totaling $5,128,900. These debentures were redeemable at the option of the investment company on 30 days' notice at par and had a touch-off clause, whereby if the net assets of the company were reduced to less than 110% of the funded debt, all of the outstanding debentures were to be redeemed at the next semiannual interest date. In addition to assuming the debentures, Tri-Continental Corporation delivered in the exchange 290,469 of its shares of common stock and option warrants to purchase 59,310 of its shares of common stock at $24 up to March 1, 1939, and 3,164 warrants exercisable at $45 per share up to April 1, 1948.[310]

Mr. Bailie testified that "one of the reasons why the owners were anxious to dispose of their situation was that it was 127% at the time when we took over." [311] Subsequently, there was a further decrease in the net assets and on April 12, 1932, the net assets of Investors Equity Co., Inc. were 125.6% of the outstanding debentures.[312]

This acquisition was advantageous to the holders of the debentures because the coverage was increased from 127% to 612%. The effect upon Tri-Continental Corporation was to spread the overhead expenses over approximately 20% more assets and to reduce slightly the deficit in the equity of the common stock. But, as the table of the asset value of preferred stock disclosed, on March 31, 1932, the net asset value of the preferred stock was $97.58 per share or "under water" to the extent of $2.42 prior to the assumption of the debentures.[313] A claim upon the assets having precedence to that of the preferred stock of Tri-Continental Corporation was created by the assumption of these debentures. The acquisition of these assets by Tri-Continental Corporation and the assumption of debentures aggregating $5,128,900 were made by its board of directors without seeking the approval or consent of the stockholders.

It should be noted that the Agreement of Consolidation in 1929 of Tri-Continental Corporation and Tri-Continental Allied Company, Inc. contained a limitation upon the power of the management of the consolidated company to issue, assume, or guarantee bonds without the consent of the preferred stock, but the limitation as specified was not very restrictive nor onerous. Under it the management was permitted, without seeking the assent of the preferred stockholders, to "issue, assume, or guarantee bonds, notes, or other evidences of indebtedness" up to the point where the aggregate principal amount

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[310] Derived from supplementary information supplied the Commission for Tri-Continental Corporation (Item 8).

[311] Public Examination, Tri-Continental Corporation, at 18578.

[312] Op. cit. supra, note 302.

[313] Op. cit. supra, note 302, Pt. I, Exhibit I–8–L. Within six weeks after the assumption of the bond issue the quarterly report disclosed that the asset value of the preferred stock was $69.24 per share or $30.76 "under water" (id., Pt. I, Exhibit I–8–M).

of such indebtedness equaled 160% of the capital stock and surplus of the Corporation.[314] The assumption of the $5,000,000 bond issue was within the power to superimpose bonded indebtedness, without the consent of the preferred stock, granted in the Agreement of Consolidation.

As a result of the assumption of the bond issue, the preferred stock, already "under water," was subordinated in priority to the claim of the debenture holders upon the assets of Tri-Continental Corporation, which were increased, of course, by the assets of Investors Equity Co., Inc.

In addition, by the purchase of $2,773,206 of assets of the Graymur Corporation, an investment company organized in Delaware,[315] the funded indebtedness of Tri-Continental Corporation was further increased. An agreement for the sale of substantially all the assets of Graymur Corporation as of December 14, 1932, was approved by both boards of directors. The stockholders of Graymur Corporation approved the agreement on January 14, 1933, and the bill of sale was dated January 27, 1933. To purchase these assets, Tri-Continental Corporation created $2,460,000 of Series A Debentures due in 1953.[316] These debentures and 123,000 shares of common stock of Tri-Continental Corporation were delivered in exchange for substantially all of the assets of Graymur Corporation.[317]

At about that time the annual report of December 31, 1932 was issued and disclosed that the asset value of the preferred stock was $88.31 per share. The next report, the quarterly report of March 31, 1933, which was issued after the consummation of the Graymur Corporation transaction, revealed that the asset value of the preferred stock was $73.84, a drop of $14.47 per share.[318]

These debentures were created and issued without the prior consent or approval of the stockholders. In this instance the board of directors, without any expression from the preferred stockholders vitally affected, directly issued debentures in contrast to the previous imposition of debentures by assumption of an outstanding issue of another company.

The asset value of the preferred stock had been consistently declining and during the period such stock was "under water" it was placed

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[314] Id., Commission's Exhibit No. 2081, III–A (p. 4). Consolidation Agreement provided:

6. The Corporation shall not, without the affirmative vote of at least two-thirds in amount of such of the preferred stock as may be present in person or by proxy and voting at a meeting of the preferred stockholders called for the purpose or the written consent of the holders of at least two-thirds in amount of the preferred stock at the time outstanding, so long as any preferred stock shall be outstanding.

* * * * * * *

(c) issue, assume or guarantee any bonds, notes, or other evidences of indebtedness, whether secured or unsecured, maturing more than one year from the issue, assumption or guaranty thereof, if immediately after the date of the issue, assumption or guaranty thereof, the aggregate principal amount of all bonds, notes or other evidences of indebtedness issued, assumed or guaranteed by the Corporation and maturing more than one year from such date shall exceed one hundred and fifty percent (150%) of the capital and surplus of the Corporation.

[315] Op. cit. supra, note 302.

[316] Ibid. The debentures issued in connection with this acquisition, created for that purpose, were convertible into Tri-Continental Corporation common stock at $12.50 per share and were callable from January 1, 1940, to January 1, 1943, at $105 and thereafter until maturity at decreasing premiums.

[317] Ibid.

[318] Id., Pt. I, Exhibit I–8–P, and Exhibit I–8–Q. It is not intended to suggest that the merger was responsible for this further decline in the asset value of the preferred stock.

in the position of having superimposed upon the assets a prior claim by the assumption or creation of debentures. The policy of seeking to spread the cost of an extensive staff of experts over a larger base of assets largely motivated the acquisition policy which, in turn, was responsible for the progressive subordination of the preferred stock.

While Mr. Bailie asserted that he regarded the preferred stock as "an investment stock," [319] the great leeway in changing the capital structure granted the management by the charter placed the management in a position to affect the "investment" character of that stock. The preferred stockholder, who, invested with the belief that he had a prior claim on the assets of the investment company, subsequently was placed in a subordinate position by the creation of a funded debt by the managers and board of directors.

6. IMPAIRMENT OF THE POSITION OF A PREFERRED CLASS OF STOCK BY THE ISSUANCE OF ANOTHER CLASS OF PREFERRED STOCK WITH EQUAL DISSOLUTION RIGHTS AND FAVORED OPEN-END PROVISIONS

a. The Kidder Peabody Acceptance Corporation

The antagonistic positions which may exist between various classes of senior securities of leverage investment companies and the harmful effects of ambiguities as to the rights and privileges of the several classes of senior securities are illustrated in the history of The Kidder Peabody Acceptance Corporation. This company was organized in Massachusetts on March 31, 1922, by Kidder, Peabody & Co., a Boston investment banking firm, and Baring Brothers & Co., Ltd.[320] to acquire the $6,000,000 of assets of the New England Investment Corporation.[321] Throughout its history, The Kidder Peabody Acceptance Corporation, although organized to deal in commercial paper, actually operated as an investment company. Its principal assets consisted of its portfolio securities.

The original capitalization of The Kidder Peabody Acceptance Corporation consisted of a $100 par value Class A preferred stock, a $100 par value Class B preferred stock, and a $100 par value common stock.[322] It was contemplated that 60,000 shares of the Class A preferred stock were to be issued to the stockholders of the New England Investment Corporation as consideration for the conveyance by the latter corporation of $6,000,000 of assets to The Kidder Peabody Acceptance Corporation. The Class B preferred stock, as will be seen, was intended to be offered to the public.[323]

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[319] Op. cit. supra, note 311, at 18544.

[320] Public Examination, Consolidated Investment Trust, at 20103 and 20116.

[321] *Crimmins & Peirce Co.* v. *Kidder Peabody Acceptance Corporation*, 282 Mass. 367, 185 N. E. 383, 88 A. L. R. 1122 (1933).

The New England Investment Corporation was organized in 1921 to acquire the assets of New England Yarn Company which had been employed in the manufacture of yarn from 1890 to 1921, when it ceased to do business as a yarn company and converted all of its assets into cash (op. cit. supra, note 320, at 20097–8).

[322] Id., Commission's Exhibit No. 3165.

[323] Op. cit. supra, note 321.

Neither of the preferred stocks had any voting privilege except on the happening of certain contingencies.[324] Both preferred stocks without distinction as to classes were entitled to a preference in assets on any dissolution of the company to $100 per share of their stock plus accrued unpaid dividends.[325] However, in one important aspect the rights of the preferred stockholders differed sharply. The holders of the Class B preferred stock were accorded by the charter of The Kidder Peabody Acceptance Corporation the right to require the corporation to redeem such stock at its par value ($100 a share) plus accrued unpaid dividends. The charter provided:[326]

> * * * The Class B preferred stock may also at the option of the holder be retired at the said redemption price [$100 a share and accrued unpaid dividends] under such conditions as the Board of Directors may prescribe at the time or times of issue, but upon not less than eighteen (18) months' notice thereof * * *.

A similar right to compel the corporation to redeem the Class A preferred shares was not accorded to the holders of such shares. In essence, the provision was intended to provide for a priority of the Class B preferred stockholders over the Class A preferred stockholders while the company was a going concern.[327] However, Kidder, Peabody & Co. apparently did not believe that the option granted the Class B preferred stockholders would ever be exercised. According to one of the partners of Kidder, Peabody & Co., the option granted to the Class B preferred stockholders was inserted in the charter because Kidder, Peabody & Co. "wanted to make something very attractive to the public, and I think couldn't conceive of a condition when it would all be turned in for payment."[328]

However, although the charter purported to give the Class B preferred stockholders an absolute right to compel the corporation to redeem their stock, this right was subject to actual and possible limitations and interpretations which might destroy or minimize its effectiveness. Obviously, the power would normally be exercised by the Class B preferred stockholders only at a time when the assets of the company were, or were about to become, insufficient to meet the combined preferences of the Class A and Class B preferred stock which it will be recalled, had an equal pari passu priority against the corporate assets on dissolution of the company.[329] However, the charter did not define the source of the corporate funds from which redemption of the Class B stock might be made. As a consequence, the charter provision was open to the interpretation that such payments could be made only out of funds in excess of assets sufficient to meet the

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[324] The preferred shares could vote if a default in one year's dividend accrued or on the question of authorizing additional preferred stock or on the matter of authorizing a sale of all the property and assets of the corporation (op. cit. supra, note 320, Commission's Exhibit No. 3165).

[325] Ibid.

[326] Ibid.

[327] Id., at 20101–2.

[328] Id., at 20101.

[329] In fact, few Class B preferred stockholders exercised their option until 1931, when the company defaulted in dividends on its preferred stock and the company's assets were insufficient to meet the full liquidating preference of both classes of preferred stock (id., at 20173 and op. cit. supra, note 321).

full liquidating preference of both classes of preferred stock. In other words, it was arguable that the option accorded to the Class B preferred stockholders could not be exercised at a time when the assets of the company were less than the capital of both classes of preferred stock.[330] Moreover, in limitation of the apparently absolute right of the Class B preferred stockholder to compel redemption of his stock was the possibility under the laws of Massachusetts that the charter provision would be ineffective if its enforcement would render the corporation insolvent.[331] Finally, the requirement of 18 months' notice of intent to redeem would serve to limit sharply the value of the right of redemption for two reasons. First, the corporation might become insolvent within the 18-month period. Second, the requirement placed upon the Class B preferred stockholders the burden of attempting to predict the financial condition of the company over 18-month period—a burden which even a competent financial analyst would find difficult.

As has been stated, 60,000 shares of the Class A preferred stock of The Kidder Peabody Acceptance Corporation were issued to the stockholders of New England Investment Corporation in return for the $6,000,000 of assets of the latter company. The record indicates that these original Class A stockholders were aware of the redemption privilege accorded to the Class B preferred stock. In fact the redemption right of the Class B preferred stock was apparently recognized as so potential a menace to the future value and preferential rights of the Class A preferred stock that the charter of The Kidder Peabody Acceptance Corporation awarded to the Class A preferred stockholders a preemptive right to the first opportunity to purchase the original and any subsequent issue of the Class B preferred stock.[332] However, in order to maintain their position unimpaired, the holders of the Class A preferred stock were required to make a further contribution to the capital of the company by exercising their preemptive right to acquire the Class B preferred stock. Whether or not the original Class A preferred stockholders were given to understand that the redemptive right of the Class B preferred stock would be effective when the assets of the company became insufficient to meet the full liquidating preference on dissolution of both classes of stock is not disclosed by the record.

The original Class A stockholders having failed to exercise their preemptive right to purchase Class B preferred stock, 40,000 shares of Class B preferred stock were distributed to the public by Kidder, Peabody & Co.[333] in April 1922. For these shares, The Kidder Peabody Acceptance Corporation obtained $4,000,000 in cash.

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[330] This argument was actually made by Class A preferred stock in a suit brought to restrain The Kidder Peabody Acceptance Corporation from redeeming its Class B preferred shares at the option of their holders (op. cit. supra, note 321). This case is discussed infra, this section.

[331] In *Crimmins & Peirce Co.* v. *Kidder Peabody Acceptance Corporation* (op. cit. supra, note 321), the Supreme Judicial Court of Massachusetts, in construing the Charter provisions giving the Class B preferred stockholders a right to compel redemption of their shares, said by way of dictum:

> It has been held that such contracts for redemption of stock are subject to the implied limitation that they cannot be enforced if the effect is to render the corporation insolvent as if there are other express limitations on the right.

[332] Op. cit. supra, note 320, Commission's Exhibit No. 3165.

[333] Id., at 20099–100.

The prospectus offering the Class B preferred shares to the public disclosed the right of the purchasers of such shares to compel the company to redeem the stock at its par value and accrued unpaid dividends.[334] In fact the option of redemption, it will be recalled, was intended to enhance the salability of the stock to the public. The record does not indicate, however, that the purchasers of the Class B preferred shares were informed of any possible limitations on the apparently absolute right to compel the company to redeem the shares. To obtain an adequate interpretation of the possible limitations on the charter provision, the prospective purchaser of the Class B preferred stock might require competent legal advice.

To complete the initial capitalization of the company, Kidder, Peabody & Co. and Baring Brothers & Co., Ltd. purchased 12,500 shares of the common stock of Kidder, Peabody & Co. for $1,250,000.[335]

Thus, on its initial issuance of its securities, The Kidder Peabody Acceptance Corporation derived $11,250,000 in capital represented by 60,000 shares of Class A preferred stock, 40,000 shares of Class B preferred stock and 12,500 shares of common stock.

In subsequent years the capitalization of The Kidder Peabody Acceptance Corporation became more complicated. In 1926, 20,000 shares of a $100 par value junior Class C participating preferred stock were issued of which 12,500 shares were sold to the public and 7,500 shares were exchanged for 7,500 shares of the company's outstanding common stock, which were retired. In 1928, the Class C preferred stock was retired and in lieu thereof $3,000,000 of second preferred stock was issued, thereby raising $1,000,000 of additional new money.[336] Whether or not the second preferred stockholders were made aware of the redemption right accorded to the Class B preferred shares is not disclosed by the record.

By 1928, therefore, the company had acquired a capital of $13,-500,000 and had outstanding 60,000 shares of Class A preferred stock, 40,000 shares of Class B preferred stock, 30,000 shares of $100 par value second preferred stock inferior in its claim against the corporate assets on dissolution to the Class A and B preferred shares and 5,000 shares of $100 par value common stock.[337]

The Class A preferred stock of The Kidder Peabody Acceptance Corporation issued to the stockholders of New England Investment Corporation was listed on the Boston Stock Exchange. Apparently the shares changed hands frequently.[338] And it may be doubted that all subsequent transferees of the Class A preferred stock were fully aware of the redemption right accorded to the Class B preferred stock—a redemption right which seriously weakened the preferential rights of the Class A preferred stockholders.

By the middle of 1931, The Kidder Peabody Acceptance Corporation had suffered large losses on its investments. In that year the company for the first time ceased to pay dividends on its pre-

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334 Id., at 20102.

335 Id., at 20103 and 20116.

336 Id., at 20103–4 and 20116.

337 See supra.

338 According to the *Commercial & Financial Chronicle,* 693 shares of the Class A preferred stock of The Kidder Peabody Acceptance Corporation were traded on the Boston Stock Exchange in the month of January 1930.

ferred stock.[339] On July 15, 1931, the company's net assets totaled $7,604,469 as compared with the $13,500,000 which had been invested in the enterprise by the company's stockholders. By November 14, 1931, the company's net assets had declined to $7,752,092. At this date the company had outstanding 58,966 shares of Class A preferred stock of the par value of $5,896,600; 39,967 shares of Class B preferred stock of the par value of $3,996,700; 30,000 shares of second preferred stock of the par value of $3,000,000 and 5,000 shares of common stock of the par value of $500,000.[340] In other words, the company's total assets were insufficient to meet the total liquidating preference of $9,893,300 of the Class A and Class B preferred stocks, which, it will be recalled, were entitled to the same and equal preference in assets on any dissolution of the company. The total assets of the company were only sufficient on liquidation to pay approximately $78 a share to the Class A and Class B preferred stockholders. The losses suffered by the Class A preferred stockholders would, however, be further accentuated if the Class B preferred stockholders exercised their option to redeem their shares at $100 a share plus accrued unpaid dividends. If all of the Class B stockholders exercised their option to redeem, the asset value of the Class A preferred stock would decline to approximately $60 a share.

Promptly after the passing of the dividends on the preferred stocks in 1931, the holders of 22,927 shares of the Class B preferred stock notified the company of their intention to compel the company to redeem such stock at $100 a share and accrued dividends after the 18 months' period prescribed by the company's charger.[341] At this time in 1931 the market value of the Class B preferred stock was about $25 a share.[342] Subsequently, all of the outstanding Class B preferred stockholders filed notices with the company of their intention to redeem their shares.

Presumably at this point a large number of the Class A preference stockholders first became aware of the existence of the option in the Class B preferred stockholders to compel the company to redeem such stock at its par value plus accrued unpaid dividends. Almost immediately a group of Class A preferred stockholders commenced a suit to restrain the company from redeeming its Class B preferred shares in accordance with the charter provision, urging that "the result as against the plaintiffs and all other holders of Class A preferred stock will be that the serious impairment of capital already existing will be greatly aggravated." [343] The plaintiffs also contended that "it is an implied condition of the issuance of the classes of stock that there shall be no redemption of Class B preferred stock, which will leave

[339] Public Examination, Consolidated Investment Trust, at 20173.

[340] Op. cit. supra, note 321.

[341] Op. cit. supra, note 320, at 20172–3. O. Kelley Anderson, an officer of The Kidder Peabody Acceptance Corporation, testified that in his opinion the remaining Class B preferred stockholders did not immediately demand the redemption of their shares because of "inertia" (ibid.).

[342] Id., at 20173.

[343] Op. cit. supra, note 321. The court granted a judgment in favor of the Class B preferred stockholders. See note 349, infra. The court, apparently cognizant of the fact that some Class A preferred stockholders may never have been aware of the Class B preferred stockholders redemption right, said, however, that:

> These provisions as to preference were doubtless on the certificate of stock * * *. The plaintiffs were in any event presumed to know of the provision. * * * Enforcement of the agreement may now seem hard to the plaintiffs, but they entered into it without compulsion and of their own choice.

the corporation in such condition that Class A preferred stock will not be worth par * * *. Stated in different form, the contention is that the structure of the corporation is built upon the theory of substantial equality between these two classes of stock." [344] The plaintiffs demanded "that the corporation * * * be restrained from redeeming any shares of Class B preferred stock until such time as this can be done without impairment of capital as against holders of the Class A preferred stock." [345]

Because of this litigation the management of The Kidder Peabody Acceptance Corporation, in order to provide the approximately $4,000,000 of funds necessary to redeem the Class B preferred stock, if the courts rendered a decision in favor of that class of stock, sold portfolio securities at substantial realized losses in 1932 and 1933, a period of low market values.[346] Thus one effect of the option right granted to one class of preferred stock was the liquidation at substantial losses of portfolio securities to the detriment of all other classes of the company's security holders.

The situation of the Class B preferred stockholders after the institution of the law suit was also difficult. They were faced with the fact that their apparently absolute right to compel the corporation to redeem their shares might be circumscribed by limitations of which they had been unaware. In other words, the protection apparently afforded them by their redemption might prove to be nonexistent.

During the pendency of the law suit The Kidder Peabody Acceptance Corporation on August 3, 1932, addressed a letter to its Class A and Class B preferred stockholders in which it offered to purchase a unit consisting of one share of its Class A and one and one-half shares of its Class B preferred stock at a price of $100 a unit,[347] equivalent to a price of $40 a share for a share of each class of preferred stock. The letter informed the stockholders of the pending litigation which, if favorable to the Class B preferred stock, would require the corporation to redeem its Class B preferred stock at a price of $115 a share (the par value of $100 plus unpaid dividends of $15).

Obviously, if the litigation was decided in favor of the Class B preferred stock, holders of such stock who accepted the company's offer would suffer a loss of $75 per share of their stock. And if a decision in favor of the Class A preferred stock was rendered by the courts, the asset value of the Class A stock would be substantially higher than the price offered for such shares by the corporation.

Thus in order to determine whether or not to accept the company's offer it was necessary that both classes of preferred stockholders predict the outcome of litigation—a prediction which even a skilled attorney could not have made with certainty. The holders of 1,000 shares of the Class B preferred stock and 1,500 shares of the Class

[344] Op. cit. supra, note 321.

[345] Ibid.

[346] O. Kelley Anderson, an officer of The Kidder Peabody Acceptance Corporation, testified that many of its assets "could have been liquidated at that time only under the most disadvantageous condition" (op. cit. supra, note 320, at 20172). Mr. Anderson further testified (id., at 20179):

> Q. It looks to me as if that lawsuit was a godsend to the Acceptance Corporation.
> A. No; it was kind of tough. We had to raise $4,000,000.

[347] Id., at 20177–8.

A preferred stock accepted the company's offer.[348] The Class B preferred stockholders who accepted the offer eventually suffered a loss of $75,000 since in April 1933 the Supreme Judicial Court of Massachusetts upheld the right of the Class B preferred stockholders to redeem their shares at $115 a share.[349] The Class A preferred stockholders who accepted the company's offer also suffered losses. They received $40 a share for their stock from the company. On October 17, 1933, the date that The Kidder Peabody Acceptance Corporation and other investment companies sponsored by Kidder, Peabody & Co. were consolidated to form the present Consolidated Investment Trust,[350] the asset value of the Class A preferred stock was approximately $65 per share (after giving effect to the redemption of the entire outstanding issue of Class B preferred stock at $115 a share).

It will be recalled that the total contributed capital of The Kidder Peabody Acceptance Corporation was $13,500,000. On October 17, 1933, the company's net assets after redemption of all the Class B preferred stock totaled $3,724,384.[351] Thus, most of the Class B preferred stockholders were paid in full and the remaining shareholders bore the entire losses suffered by the corporation.

When examined as to the propriety of the capital structure of The Kidder Peabody Acceptance Corporation, W. H. Hill, a partner in Kidder, Peabody & Co., at the inception of The Kidder Peabody Acceptance Corporation, testified:[352]

Q. So that this provision which was going to be an effective sales force * * * raised a little commotion with the corporation?

A. It did.

Q. Which all goes to prove that provisions and certificates should not be framed with an eye to sales potency but rather with an eye to an effective capitalization of the corporation, isn't that so? I suppose you agree with that observation, Mr. Hill?

A. I do.

7. LOSS IN ASSET VALUE, IN LIQUIDATION RIGHTS, AND PROTECTIVE PROVISIONS OCCASIONED TO PREFERRED STOCKHOLDERS BY THE "COMMON-STOCK CONTROL" IN THE PROCESS OF ACQUISITION AND CONSOLIDATION

It has been stressed heretofore that the complex capital structure in investment companies facilitated the securing of control over these companies by sponsor interests and the retention of that control as long as these interests regarded the continued sponsorship desirable. During the period of inflation, prior to the market set-back at the end of 1929, the leverage character of the capital structure tended to im-

[348] Id., at 20179, 20183, and 20193.

[349] Op. cit. supra, note 321. The court held that the company, at least when it was solvent, was required to comply with the charter provision granting the Class B preferred stock a right of redemption at par value, even though the effect of such redemption would be to impair further the capital of the Class A preferred shares.

[350] Op. cit. supra, note 320, Commission's Exhibit No. 3170.

[351] Ibid.

[352] Id., at 20180–1.

part a great market premium to the common stock of investment companies, concentrated in substantial amount in the hands of sponsor interests.[353] Several examples have been cited above of the numerous instances wherein sponsors disposed of a portion of their common stock holdings at a price sufficient to more than reimburse them for their entire investment in the company and yet were able to continue their domination over the company.

The holders of the senior securities who, in the case of most of the multiple-security companies, had supplied the major part of the contribution to capital did not share to any considerable extent in the profits available during the era of investment company prosperity, as the market premium on preferred stock and on bonds was naturally extremely circumscribed.[354] Only in those instances in which the senior securities had been "sweetened" by a unit sale of a senior security and a common stock did the public investor in the preferred stock or bonds have an opportunity to sell his common stock during the transiently high market to other members of the investing public.

It has already been noted that in addition to the advantages available to the sponsor in the retention of "control" as long as that appeared desirable his strategic position enabled him to transfer control of a multiple-security company at a substantial price when the latter course seemed preferable.[355] Many sponsors preferred the advantages of the sale of their "control" to the retention thereof, especially after the crash in the securities market in 1929, accompanied by the collapse in the market value of the common stocks and option warrants of investment companies, and by the extinction or diminution of many of the emoluments of sponsorship.

Examples of the premiums and emoluments obtained by sponsors who relinquished control of multiple-security investment companies have been adduced. The conflict between the interests of the holders of the senior securities of these investment companies and the interests of the new managements which had acquired the controlling blocks of junior securities was by no means terminated; it was in fact generally intensified.

The assets of the investment companies, control of which the acquirer obtained, generally "belonged" entirely to the senior security holders. The common stock had in most of these instances lost all asset value.[356] The former sponsors had relinquished control largely because they did not expect to be able to rehabilitate the companies. The acquirers ofttimes did not propose to gradually build up the acquired company, strengthen its asset position and rehabilitate the market value of its securities for the benefits of the body of existing security holders. On the contrary, the acquisition of the controlling

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[353] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. IV, pp. 320–4, and Appendix H, pp. 805–25.

[354] Ibid.

[355] "Substantial sums were * * * oftentimes paid for large blocks of leverage common stock, with little or no relation to the asset value of the security, because the holder of these stocks could manage and control the funds of other people and obtain all the benefits and emoluments of such control of the funds and of the company" (op. cit. supra, note 353, Appendix H, pp. 805–25). See supra, pp. 1595–1707, and also Ch. IV of this part of the report.

[356] See supra. See also Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II, p. 65, and Table 29.

common stock frequently represented the first step in a program of purchasing the preferred stock of these companies at a price below the asset value thereof and ultimately absorbing the acquired company into the acquiring company through a technique by which the rights and privileges of the remaining preferred stockholders of the acquired companies were to be drastically altered and reduced.[357]

Thus the senior security investor who in the period of market appreciation had been unable to profit to any extent and had been used as the "leverage" for profit to the common stock holdings was again subjected, in the period of decline, to the encroachment of common stock without asset value wielding the power of control.

The aggregate losses, in current asset value of the preferred stockholders of acquired companies, suffered through exchange programs, consolidations, and mergers, have been discussed in detail elsewhere.[358] The expansion programs often entailed disadvantages to the preferred stockholders of acquired companies other than the loss of current asset value. The exchanges, consolidations, and mergers sometimes operated to impair or eliminate protections and safety provisions possessed by the preferred stockholder prior to the acquisition.[359]

a. Consolidation of United Founders Corporation Group Into American General Corporation

The consolidation of the United Founders Corporation group of investment companies into American General Corporation presents an example of the elimination or impairment of many of the contractual rights previously enjoyed by the preferred stockholders of the companies involved.

Early in 1933, the management of The Equity Corporation commenced negotiations for the acquisition of a stock interest in United Founders Corporation.[360] By a series of transactions[361] with the sponsors of United Founders Corporation, The Equity Corporation by July 1933 had acquired 39% of the voting control of United Founders Corporation.[362] Control of the latter included the control over all the companies in the United Founders Corporation group, since United Founders Corporation held 78.7% of the common stock of American Founders Corporation, which in turn held a majority control over each of the remaining five investment companies of the group, namely, International Securities Corporation of America,

[357] See Ch. IV of this part of the report.

[358] See supra, and Ch. IV of this part of the report.

[359] Most states have adopted statutes entitling dissenters from a merger, consolidation or sale of assets, under certain circumstances, to an appraisal in payment of the value of their shares. A discussion of the inadequacy of protection afforded minorities by these appraisal statutes is contained in Ch. IV of this part of the report, pp. 1410 et seq., and the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pt. VII, pp. 342–352 and 590–610.

[360] United Founders Corporation was organized in February 1929 by Louis H. Seagrave, Christopher F. Coombs, and Frank B. Erwin (Public Examination, The Equity Corporation, at 8546, and Commission's Exhibit No. 745).

[361] For details see Ch. IV of this part of the report and the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pt. VII, pp. 213–22. See also supra, pp. 1632–3.

[362] See Ch. IV of this part of the report, pp. 1138–42.

Second International Securities Corporation, United States & British International Company, Ltd., American & General Securities Corporation, and American and Continental Corporation.[363] By securing the 39% voting power in United Founders Corporation, The Equity Corporation placed itself in a strategic position to carry out an exchange program [364] looking toward the acquisition of the still greater voting strength necessary to affect the consolidation of the entire group of investment companies.[365]

Five of the investment companies in the United Founders Corporation group had two classes of voting stock outstanding—preferred and common.[366] The Equity Corporation's investment in these companies was heavily placed in the common stock, while its interest in the preferred stock was negligible.[367] The Maryland law under which seven of the eight constituent companies had been incorporated requires for a legal consolidation the approval of two-thirds of each class of stock entitled to vote, unless the company's charter contained provisions to the contrary.[368] Five of the seven Maryland corporations had both preferred and common stock outstanding, and the preferred stock was entitled to vote under charter provisions conferring such right in the event of specified dividend defaults.[369] Thus, The Equity Corporation, which did own two-thirds of the common stock but only a small part of the voting preferred stock of the companies affected, was faced with the apparently insuperable difficulty of procuring the assent of noncontrolled preferred stockholders. Nevertheless, by the use of the voting power of the common stock alone, The Equity Corporation management purported to eliminate the necessity of a class vote. As has been noted, the Maryland law provides that a two-thirds vote by classes was necessary for the approval of the consolidation agreement, unless a corporate charter contained less exacting requirements.[370] Although the charters of the five companies in question had not at that time and never had had any such provision, The Equity Corporation, by virtue of its common-stock control, filed an amendment to the charters authorizing the approval of a consolidation agreement by a two-thirds vote of all the shares entitled to vote, thus purporting to eliminate the necessity of a class vote.[371]

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[363] Ibid. and op. cit. supra, note 360, Commission's Exhibit No. 843.

[364] See Ch. IV of ths part of the report, pp. 1138–42.

[365] A consolidation into one subsidiary corporation was desired in this instance rather than mergers of the companies directly into The Equity Corporation because the dominant interests in The Equity Corporation were averse to diluting their control of the parent company by the issuance of additional stock of The Equity Corporation which the mergers would have necessitated (op. cit. supra, note 361). Furthermore, The Equity Corporation wished to include in the consolidation another of its subsidiaries, Reliance Management Corporation, and did not desire to introduce into its capitalization a bond issue of the type on which Reliance Management Corporation was obligated (Public Examination, The Equity Corporation, at 8517).

[366] Op. cit. supra, note 361.

[367] Ibid.

[368] Md. Ann. Code (Flack, Supp. 1935) Art. 23, §§ 22, 33. The law permitted corporate charters to provide for the approval of a consolidation by at least a majority of the voting stock irrespective of classes.

[369] See Ch. IV of this part of the report, pp. 1410 et seq.

[370] Md. Ann. Code. (Flack, Supp. 1935) Art. 23, § 23. See note 368, supra.

[371] See Ch. IV of this part of the report, pp. 1410 et seq. In each case, on the same day and but one hour after the charters were amended, the consolidation was approved by virtually the same vote, with only a smal percentage of these votes representing securities held by the public (ibid.). The favorable vote cast by the preferred stock of each company was far less than two-thirds of its class (ibid.).

The charters of the companies specifically provided that the preference of the preferred stock could not be decreased except with the consent of the stockholders of at least two-thirds of the outstanding stock of the class affected by such decrease.[372] The effect of these maneuvers becomes apparent when the manner in which the consolidation operated to modify certain contractual rights and to remove certain charter protective features of the consolidated companies is considered. By the amendment to the charters, The Equity Corporation avoided the necessity of a class approval of the consolidation by preferred stockholders which seriously modified the rights of such stockholders.[373]

In four of the five companies which had issues of preferred stock outstanding, the consolidation worked substantial decreases in the rights to dividend and liquidation preferences of the owners of those issues. Decreases in annual dividend preferences ranged from \$0.60 per share in the case of American Founders Corporation to as much as \$3.60 and \$4.10 per share, respectively, for the 6% and 6½% issues of preferred stock of International Securities Corporation of America.[374] The owners of the International Securities Corporation preferred stock suffered also a severe reduction of \$40 per share in liquidation preference, having been reduced from \$100 to \$60 in liquidating value per share. Similarly, the preferred stock of United States & British International Company, Ltd. was reduced from \$50 to \$20 in liquidating value per share. Accumulations of dividends totaling approximately \$3,900,000[375] in four of these five companies were eliminated.

The protection of a par value stock where it formerly existed was also drastically affected by the consolidation. In the case of each of the three companies which had a par value stock outstanding, the par value of the new stock issues was but a fraction of the par value of the old stocks exchanged. For example, the 6% first preferred and the 7% first preferred stock of American Founders Corporation were reduced from a par value stock of \$50 per share for each issue to a par value of \$1.20 and \$1.22 per share, respectively, a decrease of \$48.80 and \$48.78 in each case.[376] Similarly, the 6% series and 6½% series preferred stocks of International Securities Corporation of America were decreased \$98.70 and \$98.68 per share in par value, respectively, reflecting a reduction from \$100 par value in each case to \$1.30 and \$1.32. Likewise, the first preferred stock of Second International Securities Corporation was reduced in par in the amount of \$48.90 per share, showing a change from \$50 par value to \$1.10 per share.[377]

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[372] Reply to Commission's questionnaire for American Founders Corporation group, Exhibit B, at 24.

[373] While The Equity Corporation, in carrying out this strategy whereby the consolidation was approved, may have complied with the technical provisions of the applicable law, the question is prescribed whether according to principles of equity a dominant interest may thus employ general power in order to override specific statutory provisions. See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pt. VII, pp. 325–35.

[374] Ibid., and Ch. IV of this part of the report, pp. 1410 et seq.

[375] Op. cit. supra, note 373.

[376] Ibid.

[377] Ibid.

Many charter protective provisions were either eliminated or specifically revised. For example, the charter of International Securities Corporation of America, prior to the consolidation, contained provisions: (a) prohibiting the additional issue of preferred stock, except in connection with the acquisition of an existing investment trust, in an amount that would have the effect of reducing the net assets of the corporation, at market value, to less than 125% of the par value of the preferred stock outstanding and, at cost, to less than 133% of par; (b) requiring a dividend reserve for the preferred stock; and (c) prohibiting loans of funds of the corporation, except upon the furnishing of collateral having a value of 125% of the loan at the time the loan was made.[378] With respect to the first two of these enumerated protective features, the charter of the new corporate entity, American General Corporation, omitted them entirely, while with respect to the third the board of directors of the new company was expressly empowered by the new charter to lend funds without requiring any security whatsoever.[379]

The Report of the Commission on the Study and Investigation of Protective and Reorganization Committees, in discussing the conflict between the desires of the preferred stockholders to enforce their contractual rights to receive their accumulated dividends in full before resumption of dividend payments on the common stock, and the desire of the common stockholders to withhold this right, points out that the technique of the acquisition of other companies and the devices of mergers and consolidations are utilized to effect a surrender by the preferred stock of accumulated dividends and other protective features of their securities which will leave the way clear, not only for the payment of current dividends on the preferred stock but also on the common stock.[380]

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[378] Public Examination, The Equity Corporation, Commission's Exhibit No. 860 (pp. 3–4, 9, and 12).

[379] Id., Commission's Exhibit No. 862.

[380] Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pt. VII, Sec. III. In connection with a plan proposed by the International Paper and Power Company which would result in the extinction of $36,000,000 of arrears of accumulated unpaid dividends on the preferred stock and the resumption of current dividends on the common, as well as the preferred stock, Commissioner William O. Douglas stated (2 S. E. C. 283 [1937]):

> Preferred like this is sold on the basis of the protective features of cumulative dividends; that is to say, if dividends are not received in periods of depression, they will be paid in times of prosperity. The history of finance shows that not only in recent years, but also in earlier periods, cumulative preferred suffered along with the common in times of depression and on the return of prosperity was deprived of its accumulated dividends and even other priorities by one or more legal devices.

Commissioner Robert E. Healy, in his opinion in connection with that plan, stated (2 S. E. C. 1023):

> Those buying preferred stock had a right to rely upon the solemn promise and contract of the company that they would be preferred both as to assets and dividends over the common stockholders.
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> * * * * * * *
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> It is difficult to observe without some concern the extent to which stockholders, in many companies, who in good faith believed that they were paying their money for a genuinely preferred position, have, through reorganization of perfectly solvent companies, such as this, through the bargaining leverage of common stockholdings, been euchered, cajoled, coerced, elbowed, and traded out of their legal rights. Although we must recognize that often, especially in failing enterprises, various changes in stockholders' rights and various concessions become necessary, nevertheless, it seems to me there should be an emphatic recognition that the terms of preference stated in preferred stock certificates mean what they say. If not, it should not be permitted that they be called "preferred."

It seems quite obvious that an opportunity to effect a shifting of asset values between classes of security holders or a readjustment of rights and safeguards of the various classes of securities by the acquisition of other companies, or by mergers and consolidations is greater in the case of investment companies and investment-holding companies than in the case of ordinary industrial or commercial corporations. For the latter types of companies to consummate a merger or consolidation, problems of cash resources, disposal of equipment and physical properties, and coalescence of function must be solved. Investment companies, constituting, as they generally do, large pools of liquid assets and being practically unrestricted in the nature of their operations can much more readily engage in the acquisition of other investment companies or the consummation of mergers and consolidations with other investment companies.

8. THE SOLICITATION OF THE PREFERRED STOCK AT PRICES DEPRESSED BY THE MANAGEMENT AND THE SUBSEQUENT LIQUIDATION OF THE COMPANY AT PROFITS RESULTING FROM THE DIFFERENCE BETWEEN THE PURCHASE PRICE AND THE ASSET VALUE OF PREFERRED STOCK

a. National Securities Investment Company

Not infrequently the sponsor and principal common stockholder of a leverage investment company can utilize his influence with the preferred stockholders to cause them to sell their shares to others at losses in asset value. This activity is normally associated with the prior transfer of the negative asset value common stock held by the sponsor to another group which is seeking to acquire the assets of the company for a total consideration less than the value of the investment company's assets. An illustration of this possible activity on the part of the common stockholder is furnished by the history of National Securities Investment Company [381] which was organized in 1926 by the investment banking firm of A. G. Becker & Co., of Chicago, Illinois. By September 1931, the net assets of the company had declined to approximately $11,000,000 as compared with assets of approximately $30,000,000 in 1929. The preferred stock of the company which was entitled on dissolution of the company to a first claim against its assets up to $100 and accrued unpaid dividends, had in September 1931 a liquidating value of approximately $80 a share but was selling in the market at a price of $50 a share. The 939,144 shares of the common stock of the company, of which A. G. Becker & Co. had acquired 641,658 shares at a cost of $1,900,000, had no asset value.

On September 25, 1931, A. G. Becker & Co. and Atlas Corporation reached an agreement which provided that Atlas Corporation was to purchase A. G. Becker & Co.'s holdings of the common stock of National Securities Investment Company at a price of $3 a share or a total price of $1,900,000—the actual cost of the shares to A. G. Becker & Co., although the common stock at this time had no asset value what-

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[381] For a detailed discussion of National Securities Investment Company and other instances of this type of activity, see Ch. IV of this part of the report.

soever. Atlas Corporation, however, was to pay A. G. Becker & Co. the stipulated price for the latter's common stock after Atlas Corporation acquired the preferred stock of National Securities Investment Company at prices less than the asset value of the preferred stock. In other words, a portion of the ultimate gain in asset values to be derived by Atlas Corporation through its purchase of National Securities Investment Company preferred stock at less than asset value was to be paid over to A. G. Becker & Co. in the price Atlas Corporation was paying the sponsors for their common stock.

The agreement provided that A. G. Becker & Co., which had been actively supporting the market in the preferred stock of National Securities Investment Company, was not to compete with Atlas Corporation in the purchase of the preferred stock of National Securities Investment Company, but was to buy such stock only for the account of Atlas Corporation. A. G. Becker & Co. became Atlas Corporation's brokers and purchased the preferred stock of National Securities Investment Company at prices fixed by Atlas Corporation—prices which were substantially below the asset value of the shares, although higher than the market price of comparable investment company securities.

On September 25, 1931, the market price of the preferred stock of National Securities Investment Company was $50 per share. On September 30, 1931, five days later, as a result of the cessation of market-supporting activities by A. G. Becker & Co., the passing of dividends on the preferred stock and a general market decline, the market price of the preferred stock of National Securities Investment Company was $37 a share.

Of 92,974 shares of the preferred stock of National Securities Investment Company purchased by Atlas Corporation between 1931 and 1935, the year of the dissolution of National Securities Investment Company, 740,072 shares were purchased through A. G. Becker & Co. Atlas Corporation also acquired in addition approximately 60,000 shares of the preferred stock of National Securities Investment Company by means of exchange offers of Atlas Corporation's securities. These exchanges were recommended to the preferred stockholders of National Securities Investment Company by A. G. Becker & Co., apparently without disclosure to such stockholders of the fact that A. G. Becker & Co. was to receive commissions from Atlas Corporation for its service in this connection.

Preferred stockholders of National Securities Investment Company who sold their shares to Atlas Corporation or exchanged them for the latter company's shares suffered immediate losses in asset values of approximately $1,880,000. However, A. G. Becker & Co., which aided Atlas Corporation in acquiring the preferred stock succeeded in selling its common stockholdings in National Securities Investment Company, which had no asset value at this time, for $1,900,000. Robert C. Schaffner, chairman of the Board of A. G. Becker & Co., testified as follows: [382]

Q. And necessarily, A. G. Becker & Co., and for that matter, Atlas Corporation, would only gain under those circumstances at the expense of the stockholder, isn't that so?

A. At the expense of the stockholder who sold——

[382] Public Examination, National Securities Investment Company, at 14382.

Q. That is right?

A. Yes.

Q. And a stockholder who sold his stock was an individual entitled to $73.32. The peg is pulled, the stock declined; the stock is picked up and the sponsor is getting a cut on the difference between the asset value and the market value, isn't that so?

A. Yes.

9. PREVENTION OF POSSIBLE DISPLACEMENT OF THE EXISTING "MANAGEMENT" THROUGH THE CONTINGENT VOTING PARTICIPATION OF THE PREFERRED STOCK

a. American Capital Corporation

The American Capital Corporation, one member of a group of investment companies [383] sponsored and controlled by the Jonathan B. Lovelace and E. E. MacCrone and Company interests, was incorporated in May 1928 in the State of Delaware.[384] Its capital structure comprised issues of prior preferred and preferred stock and common stock (Classes A and B).[385] By provision in the Certificate of Incorporation [386] the common stock was endowed with sole and exclusive voting power for all corporate purposes, subject, however, to certain contingent voting rights granted to each class of the preferred.[387] The prior preferred was entitled to the payment of dividends before any dividends could be paid upon or set apart for any other class of the outstanding preferred and common stock of the American Capital Corporation.[388] Upon the company's default in these dividends for a period of two years exclusive voting power was then to vest in the prior preferred,[389] There was a similar provision for the protection of the holders of the preferred stock. Subject to the rights of the prior preferred exclusive voting power likewise was to vest in the preferred stock upon default for a period of two years of full payment of dividends due on this class of the capital stock.[390]

From its inception, American Capital Corporation remained under the control of closely identified sponsor and management interests. These individuals by means of management contracts, intercompay, and personal stockholdings and a closely-woven interlocking of officers and directors, maintained their control of each of the companies within the American Capital Corporation group. While in the normal course, control of American Capital Corporation by the sponsor interest was not seriously threatened, yet it was possible under the terms of the Certificate of Incorporation for the exclusive

[383] Including The Investment Company of America, Pacific Southern Investors, Inc., and Pacific Investors, Inc.

[384] Reply to the Commission's questionnaire for American Capital Corporation, Pt. I (Items 1 and 5).

[385] Id., Pt. II, Exhibit A.

[386] Id., Pt. I, Exhibits A and B.

[387] Id., Exhibits A and B, Sec. Fourth, K, 1 (p. 8).

[388] Id., Sec. Fourth, a (p. 5).

[389] Id., Sec. Fourth, e, (p. 6).

[390] Id., Sec. Fourth, i, (p. 8).

voting power to vest in the preferred stock.[391] This possible threat to management—the common stock stripped of all voting power and exclusive voting power transferred to holders of preferred stock—did become imminent. The inside interests protected themselves against this contingency by having another company within the group, concurrently with the defaults in dividends on the part of American Capital Corporation, acquire the necessary amount of the preferred stock of the latter company.

In 1933, when American Capital Corporation first passed the regular dividend payment due on its outstanding preferred stock,[392] The Investment Company of America [393] began to acquire substantial holdings of the defaulted preferred. By December 31, 1934 it had acquired, at a cost of $274,199.00, 16,861 shares of the preferred stock of the American Capital Corporation.[394] During this period, American Capital Corporation had been defaulting with regularity on this same issue of preferred stock. Although partial dividend payments were made during the period, by December 31, 1935, the stock had fallen into arrears of 2½ years.[395] On this date, Pacific Southern Investors, Inc.,[396] held 20,637 shares of the defaulted preferred stock of American Capital Corporation, 960 shares of which had been acquired during 1934.[397] Of the balance acquired during 1935, 16,761 shares represented the holdings in this stock by The Investment Company of America as of December 31, 1934. Pacific Southern Investors, Inc. had acquired this block of preferred stock from the Investment Company of America by means of an intercompany exchange of securities during 1935 on an equal market value basis.[398] This total of 20,637 shares of the preferred stock of American Capital Corporation held by Pacific Southern Investors, Inc. at the close of 1935 represented 20% of the 102,450 shares then outstanding [399] and this block might reasonably have been expected to constitute working control of the company's affairs when exclusive voting power vested in the preferred stock.

The existing management which heretofore had held control of American Capital Corporation as long as voting power resided in the common stock,[400] may have been in an even better position with regard to control with the vesting of exclusive voting power in the preferred. By virtue of intercompany and personal holdings and the interlocking

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[391] See supra, p. 1798.

[392] Reply to the Commission's questionnaire for American Capital Corporation, Pt. IV, Item 27 (b) and Pt. V, Item 39.

[393] A group member. See infra.

[394] Reply to the Commission's questionnaire for The Investment Company of America, Pt. III.

[395] Op. cit. supra, note 392.

[396] Another group member. See infra.

[397] Reply to the Commission's questionnaire for Pacific Southern Investors, Inc., Pt. III.

[398] Derived from supplementary information supplied the Commission for Pacific Southern Investors, Inc., Table 41.

[399] Reply to the Commission's questionnaire for American Capital Corporation, Pts. II and IV, Item 28, Table 7.

[400] At the close of 1935, officers and directors of American Capital Corporation personally held a total of 52,438 shares of the common stock of American Capital Corporation (op. cit. supra, note 399, Pt. V, Table 15) or 7% of the 743,134 shares outstanding (id., Pt. V, Table 15a, and derived from supplementary information supplied the Commission for American Capital Corporation). Including 78,901 shares held by Pacific Southern Investors, Inc., the percentage amounts to 17.7% (ibid.).

of offices and directors this same management in American Capital Corporation was able to direct the voting of the 20,637 shares of the preferred stock of that company then held in the portfolio of Pacific Southern Investors, Inc.

Pacific Investors, Inc. held nearly 40% of the voting common stock of Pacific Southern Investors, Inc. at the close of 1935.[401] Officers and directors who were identified with all three companies held more than 50% of the voting stock of Pacific Investors, Inc.[402] In addition to these substantial intercompany and personal holdings, practically all of the officers and directors of American Capital Corporation were also officers and directors in both Pacific Southern Investors, Inc. and Pacific Investors, Inc.[403]

With continued default by American Capital Corporation on its preferred stock dividends, exclusive voting power vested in that class of stock. Accordingly, a meeting of the shareholders[404] of American Capital Corporation was held on April 27, 1936. Of the total 102,450 preferred shares outstanding, 53,676 shares were represented by proxy at the meeting.[405] Of this total represented by proxy, 20,637 shares or 38.5% of the total shares voted were then held by Pacific Southern Investors, Inc.[406] The existing management of American Capital Corporation remained unchanged.[407]

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[401] For number of shares held by Pacific Investors, Inc., see op. cit. supra, note 397, Pt. V, Item 52, Tables 15 and 15a; for total shares outstanding of Pacific Southern Investors, Inc., see id., Pt. IV, Item 28, Table 7.

[402] For number of shares held, see op. cit. supra, note 398, Pt. V, Item 52, Tables 15 and 15a; for total shares outstanding, see id., Pt. IV, Item 28, Table 7.

[403] See the following:

Name of officer or director	*Positions held*
Henry S. McKee	President and director of American Capital Corporation, Pacific Southern Investors, Inc., Pacific Investors, Inc., and director of The Investment Company of America.
E. J. Nolan	Treasurer and director in American Capital Corporation, Pacific Southern Investors, Inc., and director in Pacific Investors, Inc.
Edward D. Lyman	Vice president and director in American Capital Corporation, Pacific Southern Investors, Inc., and Pacific Investors, Inc., and director of The Investment Company of America.
N. Spencer Dennis	Vice president and director in American Capital Corporation, and Pacific Southern Investors, Inc., and director in Pacific Investors, Inc.
Jefferson P. Chandler	Director in American Capital Corporation, Pacific Southern Investors, Inc., and Pacific Investors, Inc.
Jonathan B. Lovelace	President and director, The Investment Company of America; chairman of the Investment Committee and director in American Capital Corporation and Pacific Southern Investors, Inc., and director in Pacific Investors, Inc.
Lindley C. Morton	Director in the American Capital Corporation, Pacific Southern Investors, Inc., and Pacific Investors, Inc.
E. A. Orwig	Secretary and assistant treasurer in American Capital Corporation, and Pacific Southern Investors, Inc., and Pacific Investors, Inc.
Frederick Hore	Assistant secretary in Pacific Southern Investors, Inc., and American Capital Corporation, and assistant secretary and assistant treasurer in Pacific Investors, Inc.

[404] Only the preferred stockholders attended as voting power now resided exclusively in them.

[405] Derived from supplementary information supplied the Commission for American Capital Corporation.

[406] See supra, p. 1799.

[407] It was voted at this meeting to award Jonathan B. Lovelace, a director in all three of these companies, a call on 70,000 shares of the Class B common stock of American Capital Corporation, exercisable at $1.00 per share at any time on or before December 31, 1941. The right, however, was not to become exercisable until such time as the asset value

10. DISSIPATION OF THE ASSETS OF THE COMPANY AND "UNLOADINGS" UPON THE COMPANY BY THE "COMMON STOCK CONTROL," THUS RENDERING INEFFECTIVE THE RIGHTS OF PRIORITY ON DISSOLUTION AND LIQUIDATION GRANTED THE SENIOR SECURITIES

It was stressed above that the preference up to the par of their shares or up to a stated amount in the distribution of assets upon dissolution is considered one of the most vital attributes of preferred stock.[408] The fixed priority in dissolution [409] purports to accord the preferred shareholders the element of greater security as a substitute for the right to unrestricted participation in surplus profits generally awarded to common stockholders. Nevertheless, in the investment company field, this provision has been found inadequate, to a large extent, to protect the preferred stock from exploitation by and in favor of the common stockholder.[410]

The preferred stock has generally been denied an effective participation in the management.[411] The administration of affairs and the disposition of assets in the operation of companies have been largely concentrated in the hands of common stockholders.[412] The latter have thus been in a position to dissipate assets in connection with self-serving enterprises or to unload properties of dubious value upon the companies or to route to themselves the avenues of profit with the result that upon dissolution little or no assets are available to satisfy the priority rights of the preferred stock.

The many ways in which "managements" have denuded investment companies of assets through implicating companies in activities motivated by objectives ulterior to consideration of the companies' welfare are described in detail in other parts of this report.[413] Several of the companies whose histories have been described in detail in an earlier chapter of this report [414] pointedly illustrate this phenomenon. So far as the multiple-security company is concerned, it is obvious that once common stock equity has disappeared, any further dissipation or reduction of assets is entirely at the expense of the senior securities.

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of the Class A common stock should equal $32 per share. This class of common had an asset value of $21.03 per share at the time the right was awarded. The purpose of this award, it was said, was that it served as a remuneration to Mr. Lovelace for his past services to the company through his research organization, the Investment Research Corporation, and to assure his continuance in the management.

The option was granted when the Class B was selling at about $21. At the time the Class A would have reached $32 per share in asset value, making the call on the Class B exercisable, the Class B would still have had no asset value of its own, and thus the exercise of the right by Mr. Lovelace at $1.00 per share would not operate to dilute the Class B. If, however, the asset value of the B stock rose to above $1 and Mr. Lovelace then exercised his right, a dilution would be effected.

[408] See supra, pp. 1569–75.

[409] Possibly derived from the theory of the return of principal involved in the loan of funds. Stevens, W. H. S., "Participation in Assets in Dissolution," *The Journal of Business of the University of Chicago* (1937), Vol. X.

[410] This is not intended to imply that in other fields this fixed priority has proven adequate.

[411] See supra.

[412] See supra.

[413] See Ch. VII of this part of the report which relates to the management of assets, and also the detailed histories of investment companies in Ch. II.

[414] See Ch. II of this part of the report.

B. Specific Inequities in Relation to Bonded Indebtedness—Conflict of Interest Between Debentures and Equity Securities [415]

The term "funded debt" [416] or "bonded debt" may be defined as the fixed obligations of the company, for a more than transient borrowing of capital, evidenced by an indenture which contains all of the provisions for security and repayment, and under which units evidencing the debt, called debentures, are issued. The debentures also contain an abridged statement of the amount, date, period, and provisions for security and repayment.

The indentures may be either collateral trust agreements, that is, agreements which provide that specific collateral, usually deposited with the trustee, shall be security for performance of the company's obligations thereunder, or debenture indentures, which do not provide specific collateral security, but make certain provisions for repayment, maintenance of asset ratios, sinking fund, interest payments, and such matters. Or, classified otherwise, they may be either closed-end or open-end in form, that is, may provide that all the bonds to be issued shall be constituted of the original issue and specifically provided for in the indenture, or may provide for subsequent issues under the same indenture, provided certain requirements are met.

The indenture is in form an agreement under seal whereby the issuing company agrees with the trustee as to all pertinent matters and whereby, for a consideration, the trustee agrees to authenticate the issue, care for the mechanics of payment, keep safe the collateral, if any, and act as the representative of and conservator for, the bondholders' interests.

Since the bondholder, generally, has a fixed limited priority claim to interest and distribution of assets on dissolution and normally has no right to participate in the management nor any right to surplus profit, he has been grouped with the preference stockholder in the general category of "senior security holder." [417] The discussion in the preceding section [418] concerning the incompatibility of the interests of "senior securities" and "equity securities" in the multiple-security investment company embraced the bondholder as well as the preference stockholder. This section of the report will discuss the problems relating to bonds and debentures in connection with (1) the failure to provide adequate protective features in debentures; and (2) the ineffectiveness of protective clauses to safeguard bond or debenture holders.

The supposed advantage of the creditor status of the bondholder, in contrast to the proprietary status of the stockholder, may at times be illusory.[419] While the bondholder is the recipient of a promise to pay fixed amounts of interest at fixed intervals and to return his principal at the fixed maturity date, he is nevertheless like any other creditor, secured or unsecured, not immune from the risks and uncer-

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[415] Of the 186 incorporated and unincorporated investment trusts and investment companies of the management type studied, 33 trusts and companies had funded debt outstanding on or at some time prior to May 26, 1936.

[416] See supra, p. 1570–2.

[417] See supra, p. 1576. The bondholder generally also has a fixed limited priority to the amount of principal on the maturity date and to the amount of interest on the interest date.

[418] See supra, p. 1594–1707.

[419] Dewing, A. S., *Financial Policy of Corporations* (3d rev. ed., 1934), pp. 103–8.

tainties of the corporate enterprise. In many fundamental respects, the bondholder's position of creditor is no different from the position of a stockholder. Realistically the bond or debenture holder can receive his interest like the stockholder his dividends, if such distributions are not to constitute a return of capital, only from the earnings of the enterprise. If the corporation suffers losses instead of earning profits, the bondholder is unable to procure his "interest" just as the stockholder will fail to receive his "dividends." The bondholder, like the stockholder, has no assurance that the enterprise will be profitable.

In investment companies, perhaps more often than in other fields, provisions are found which presumably aim at protecting the bondholder prior to the time when there has been a default in payment of principal or interest—such as the required maintenance of a margin of assets above the principal amount of bonds (a "touch-off" clause), which purports to secure to the bondholder full liquidation of his debt while there are still sufficient assets of the corporation. Such provisions are comparatively rare in the case of preferred stock. The bondholder therefore would appear to be in a more protected position than the preferred stockholder throughout the history of the company—aside from the former's status of creditor. It will be shown, however, that such supposed safeguards have been rarely enforced or enforceable and that their presence has not proved an unqualified advantage to the bondholder. Moreover, in many instances no attempt has been made to grant even such safeguards to the bonds or debentures. In such instances, the debenture holder has been in substance little more than a first preferred stockholder, without any voting rights, regular or contingent.

In addition to the many vital problems of economic and corporate finance, created by bonds or debentures in the capital structures of investment companies, the presence of these types of securities in the capitalization of an investment company, because of the nature of the bondholder's claim, engenders conflicts of interest between the holders of these securities and the holders of equity securities which may be detrimental to both these classes of security holders.

In many respects the antagonism of interests between the bondholder and the common stockholder in an investment company is similar to that which exists between the holders of preferred stocks and of common stocks. The character of the bondholder's claim against the corporate assets accentuates this conflict between different classes of securities in the capital structure. Preferred stockholders have a preferential ownership interest in the corporate assets and a preferential claim against the corporate earnings. However, this ownership interest usually is realizable only in a dissolution or winding up of the investment company. But the preferred stockholder normally has no power to compel a dissolution of the company, since the common stock is almost universally vested with the sole power to

[420] The state laws usually authorize a voluntary dissolution of a corporation only on the vote of the holders of two-thirds of is voting securities. See Ch. IV part of the report, pp. 1410 et seq. In few cases are the preferred stockholders of an investment company granted two-thirds of the voting power even on a default in the payment of dividends. Normally an involuntary dissolution of the investment company will occur only because of its inability to meet the claims of creditors such as bondholders, or because of action by state officials for noncompliance with the laws of the state of incorporation of the company.

compel a dissolution of the company.[420] As a consequence, a decline in the assets of the investment company to an amount equal to or less than the total of the preferred stockholders' liquidating preference on dissolution or a default in dividends on the preferred stock gives the preferred stockholder no right to compel payment of his preferential claim; at most the dividends accumulate and serve to augment the preferential claim of the preferred stockholder on any dissolution. The management, therefore, is under no compulsion to adjust the corporate investment policies in a manner which will protect the preferential claims of the preferred stockholder.

However, the claim of the bondholder against the corporate assets of investment companies is that of a creditor. As such, the bondholder on a default in payment of interest or principal may in the proper circumstances institute legal proceedings to subject the corporate assets to the satisfaction of his claim. And, unlike the case of industrial companies, the possibility of reorganization proceedings which will alter or change the nature of the bondholder's claim in an investment company is remote. The fact that the assets of industrial corporations normally have no ready market or can only be sold at a sacrifice in value usually impels bondholders in such companies to submit to a reorganization of their rights and claims in order to retain a large proportion of the actual value of their investment. In contrast, however, the assets of investment companies normally have a ready and ascertainable market. They can be easily liquidated to satisfy in part or in full the claims of bondholders. As a result, the holders of the equity securities of an investment company (and usually the management of such companies are large holders of equity securities) face a possible liquidation of the corporate assets which will wipe out the interests of junior security holders if a default on the company's outstanding debentures or bonds occurs. At best a reorganization of the company with control of the management and investment policies of the company transferred to the debenture holders may occur. Obviously this power of the bondholder to satisfy his claim against the corporate assets is antagonistic to the interests of the equity security holders in investment companies. Consequently the power of the bondholder to reduce his claim to judgment will frequently be hampered and impeded by provisions in the indentures creating the bonds—the terms of which indentures are solely within the control of the managements of investment companies, who are frequently the largest holders of the equity securities of investment companies.[421]

Similarly the desire of the bondholder for security for his claim is sharply opposed to the desire of the equity security holder for a more or less speculative policy of investment. From the viewpoint of the common stockholders the important function of the presence of bonds in the capital structure is to supply funds which will impart a "leverage" to the common stockholder's securities. In other words, the interests of the common stockholders would require the investment of the fund derived from the bondholder in securities which have large possibilities for appreciation in value but which, conversely, may involve a substantial risk of loss. However, the bondholders, to insure a relative stability in the value of the corporate assets at

[421] Provisions of this nature are also common in the trust indentures of the bonds of industrial and other companies.

least equal to the face amount of the investment company's outstanding debentures, would desire to have the funds derived from the bonds invested in securities of relatively stable market values such as bonds and preferred stocks. In practice, however, this conflict has been resolved in favor of the common stockholders.[422]

In fact, provisions ostensibly for the security of bonds of investment companies appear to have been devised to provide a minimum of actual security to the bondholders and a maximum of opportunity for managements to invest the proceeds of bond issues in common stocks; that is, to use the bondholders' funds to the advantage of the leverage in the equity securities of the investment company.[423] As has been stated, the usual provision with respect to security for the bonds is the so-called "touch-off" clause, that is, a requirement that the value of the net assets of the investment company must at all times be an amount bearing a specified ratio, usually 125% to the face amount of the investment company's debentures. Rarely is any specific security allocated to the "bonds."[424] The claim of the "bondholders" is merely a general claim against the corporate assets.

The protection to bondholders of the "touch-off" clauses has, however, been circumvented by other provisions in the indentures creating the bonds of investment companies. For example, as will be described later, the indentures usually do not provide for any independent

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[422] The portfolio securities of investment companies with bonds in their capital structure have consisted predominantly of common stocks. At the year-ends 1930 to 1936, inclusive, the proportion of common stock portfolio securities to total assets of investment companies having bonded indebtedness was as follows (Pt. Two [House Doc. No. 70, 76th Cong.], Ch. II, Table 36 of this report):

1930	*1931*	*1932*	*1933*	*1934*	*1935*	*1936*
62.0%	49.5%	50.8%	64.2%	62.3%	68.1%	71.2%

Another factor which militates against the purchase of bonds or preferred stock for the portfolio of investment companies having outstanding bonded indebtedness is the necessity for large earnings to cover the fixed charges of the senior securities. Thus, Erwin Rankin, an officer and director of the various investment company subsidiaries of United Founders Corporation, testified (Public Examination, American General Corporation, et al., at 24875):

> For instance, when an investment company has a bond on which they have to pay 5% and pay 6% on the preferred, let us say the over-all is a 5% requirement on its capital, that company can't very well afford to be buying bonds that yield 3 to 4%.

[423] "No doubt a sense of added assurance is given to the owner of an investment trust bond, if he knows that the issuer has invested in well-protected senior securities an amount of capital equal to, or greater than, its total outstanding obligation; but few instances can be cited of any such requirements in the issuance of investment trust bonds * * *." Robinson, L. R., *Investment Trust Organization and Management* (1929), pp. 256–7.

[424] Of 44 bond issues sold by 33 of the investment companies replying to the Commission's questionnaire, only 12 issues were secured by collateral. The selection of the collateral, moreover, was placed entirely in the hands of the management of the investment companies who invariably also had the sole power to make any substitution in the collateral. The type of collateral securities, whether bonds, preferred stocks, or common stocks, also was left to the complete discretion of the management. In fact nothing prevented the management from using the investment company's own common stock as collateral. Dividend interest and profits on sales of the collateral security also invariably were awarded to the investment company itself and were not used to augment the security of the bondholders. In all cases the trust indentures contained a provision similar to a "touch-off" clause, and subject to the deficiencies of such clauses discussed infra, requiring the value of the collateral at all times to be equivalent to a specified percentage, usually 125% of the face amount of the outstanding debentures. However, in only 3 cases was there any provision permitting (but not requiring) the indenture trustee to make an independent appraisal of the value of the collateral. In all other cases the appraisal of the value of the collateral was confined exclusively to the management of the investment company.

appraisal of the corporate assets; the determination of the value of the assets of the investment company usually is placed exclusively in the hands of the company's management which may have a self interest in avoiding the incidence of the "touch-off" provisions.

Moreover, in practice the operation of the "touch-off" clause has proved disastrous to common stockholders, and has not been without harmful results to bondholders. It has been noted that usually the management inclines toward adopting the more speculative policy favored by the common stockholder rather than the more conservative policy favored by the bondholder. However, when a period of seriously declining security values sets in, so that the impingement of the "touch-off" clause becomes imminent, the management is frequently faced with the unavoidable necessity of reversing its policy and liquidating the existing portfolio at great sacrifices in order to reinvest the funds of the company in securities of relatively stable market values, such as government bonds, for the protection of the bondholders.[425] Thus at the very time when the purchase or retention of securities with substantial possibilities of appreciation in value might be particularly desirable from the standpoint of the common stockholder, the existence of "touch-off" clauses will compel managements to adopt a static policy of investment in securities of relatively fixed value.[426]

The "touch-off" clause may also create problems for the bondholders. Declining market values of portfolio securities usually will cause a decline in the market value and in the marketability of the bonds as

[425] Thus, Ray Morris, an officer and director of Standard Investing Corporation, testified with respect to that company's change in investment policy as the result of a possible default occurring on its bonds in a declining market for securities (Public Examination, General Investment Corporation, at 15243–4):

A. * * * We were certainly handicapped in feeling the necessity of selling stocks in the low markets, 1932, to protect our bonds.

Q. I am curious about that. You said that you had to sell your stocks at the lower point of the market to protect your bonds; why was that?

A. We didn't have to, but in 1932 at the low, there were certainly some weeks when our bonds were not fully covered with assets and you couldn't tell how much lower the market was going in those days and the directors thought they were protecting the bonds by selling stocks and holding cash or buying government bonds or something of the sort or a coverage for the bonds because they thought that the assets might continue to shrink to a point where defaults on the bonds would be brought about. Now in the light of retrospect that was wrong. If we held the stock, we would have done much better, and to that extent that was undoubtedly bad management, because it was bad judgment.

Q. The thing that I am interested in here was a case where certain investment policies were dictated by the requirements of a complicated capital structure in the trust; isn't that so?

A. That is true.

Q. So that you had a situation in the trust with a funded debt, and the policy of the corporation was diverted primarily not so much by the advisability of liquidating the portfolio at that time but by the exigencies of protecting the funded debt, isn't that so?

A. That is exactly correct.

Q. Looking back in retrospect, would you say that you would favor such a complicated structure for investment trusts?

A. No; definitely not.

See also the testimony of Morton H. Fry and Ambrose Benkert, directors of Reliance International Corporation and Reliance Management Corporation, infra, pp. 1838 and 1842.

[426] Thus Earle Bailie, the chairman of the board of directors of Tri-Continental Corporation, testified (Public Examination, Tri-Continental Corporation, at 18757–8):

Q. Do you know of any case in which a touch-off clause as to investment trusts has been put into operation when the bonds went into default?

A. There may have been. I don't know of any. I know of a good many managements that have been hamstrung for six months a year.

Q. Hamstrung?

A. They could not do anything. They had to turn over assets into cash to protect themselves or buy bonds and increase the coverage. The whole thing is very unfortunate.

their coverage in assets declines. As a result, managements have been provided with an opportunity to repurchase the investment company's bonds at prices substantially less than the face value. The management may pursue a policy of repurchasing its outstanding bonds at a price as low as possible in order to decrease the bonded indebtedness at a greater rate than a decline in value of the corporate assets. This procedure will benefit the common stockholders by increasing the asset value of the equity securities and when the price paid is less than the asset value of the bonds—as is frequently the case—will result in the retiring bondholders receiving less than the sum to which they would obtain on a liquidation of the company or the enforcement of the "touch-off" clause. In some instances the proposal of repurchasing bonds at a large discount was accompanied by the thought that the company having been temporarily freed from the menace of the "touch-off" provision might continue or renew a speculative policy with the remainder of the corporate funds in order to afford the junior shareholders "the chance to come back." [427]

The complexities and problems introduced by the substantial conflicts between the interests of the common stockholder on the one hand and the desire of bondholders for a secured position for their investments on the other and the further dilemma presented by the "touch-off" provision—the danger of its absence and the menace of its presence [428]—raises the question of the propriety of bonds in the capital structure of investment companies.

1. FAILURE TO PROVIDE ADEQUATE PROTECTIVE FEATURES IN TRUST INDENTURES

a. Shawmut Bank Investment Trust

The entire capital of Shawmut Bank Investment Trust was contributed by purchasers of debentures who received without cost, in

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[427] See the conflict of policy in this regard in the case of The Investment Company of America described in Ch. IV of this part of the report, pp. 1237–77.

[428] In view of the disfavor in which the "touch-off" provision is held by a substantial part of the industry, the future tendency may well be to withhold that type of protection from the bondholder. Mr. Bailie testified (Public Examination, Tri-Continental Corporation, at 18757):

> It [a touch-off provision] is certainly impractical, and I have never seen a touch-off clause that was practicable because it gives the investor a feeling of safety which he ought not to have just at the moment when securities should not be sacrificed. They have the contract that they shall be sacrificed, and I think they are of the devil.

Under these circumstances the so-called uncollateralized "bonds" will be hardly more than wholly unsecured claims having—aside from the legal right to compel payment on a default in principal or interest—essentially the same attributes and bearing essentially the same risks as junior securities. Mr. Bailie testified (Public Examination, Tri-Continental Corporation, at 18749):

> Q. What protection should there be for senior securities when the assets fall below the amount of the outstanding senior securities?
> A. I think that the only protection that the senior security needs in an honestly managed company is the knowledge of what the assets are, backed up by the further fact that they get the first money taken out. That means in certain cases an unsecured debenture may not pay 100 cents on the dollar, but that it is not limited to the investment-company field. That is a situation which occurs throughout industry when a company is successful.
> Q. Would you suggest calling them debentures, which is a high-sounding name, when they are unsecured promisorry notes? * * *
> A. Unsecured promissory notes.

addition to these debentures, warrants which enabled the holders to obtain the common stock issued by the investment company.[429]

The debenture holders were the recipients of practically none of the safeguards or protections which frequently accompany bonds or debentures. The debentures were not supplied with a cushion of assets; they had no "touch-off" clause; no sinking fund requirements; no reserve for interest; no provisions precluding the payment of dividends on common stock before interest on the debentures was fully paid or when the debentures were not fully covered by assets; no prohibition against the issuance of additional debentures having a priority over or a parity with existing debentures except in certain instances; no provision automatically accelerating the maturity of the debentures in the event of default in the payment of interest; and no provisions specifying events of default or remedies upon defaults. There was no separate indenture for the debentures, nor was a trustee provided for the debenture holders. The rights, limitations, description, and other matters relating to the debentures were contained in two pages of the declaration of trust under which Shawmut Bank Investment Trust was formed and under which the trustees of Shawmut Bank Investment Trust were vested with the management.[430] In short, the debenture holders were almost wholly unprotected creditors of the investment trust.

The original capitalization of the investment trust supplied no margin of assets whatsoever above the principal amount of debentures issued. The investment trust sold $6,000,000 face amount of debentures—$5,000,000 of debentures to the public and $1,000,000 of junior debentures to the sponsors for which the investment trust received a net aggregate of $5,990,000.[431] The common stock, given as a kind of bonus to the debenture holders, did not contribute to the investment trust's resources.[432] Hence, at the formation of the investment trust the aggregate indebtedness to all the debenture holders exceeded the entire net contributions to capital. A "touch-off" provision with this type of capitalization was manifestly impossible since no margin of assets over principal amount of debentures existed at the start.

Inasmuch as the debentures had no "cushion," the security of the principal as well as the likelihood of interest payments depended entirely on the earnings and profits derived from the trust's assets. Since these assets consisted largely of portfolio securities subject to wide and rapid market fluctuation, the precarious position of the debentures is obvious. From 1931 to 1936 the debentures were "under water."[433] In May 1932, the $6,000,000 fund contributed by debenture holders had shrunk to less than $3,000,000.[434] Had there been the protection afforded by a "cushion" of junior money supplied by other than debenture holders, the impairment of bondholders' capital

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[429] For a discussion of the capital sturcture and leverage features of this company see supra, pp. 1618–19. For the distribution aspects of this company see Ch. III of this part of the report, pp. 904–8.

[430] Reply to the Commission's questionnaire for Shawmut Bank Investment Trust, Pt. I, Exhibit A.

[431] Public Examination, Shawmut Bank Investment Trust, at 3295.

[432] Op. cit. supra, note 430, Exhibit A (pp. 13–14).

[433] Id., Pt. IV, Table 7A.

[434] Id., Exhibit Item 8.

would naturally have been less. Had there been such a cushion originally and also a "touch-off" clause, the bondholders would have been in a position to take steps to secure the full liquidation of their claims before the actual impairment in their principal had taken place.

No sinking fund arrangement was provided, nor any other requirement of a reserve for interest. The company's pattern of capitalization rendered the maintenance of any such reserve for interest or sinking fund extremely improbable and in actual experience not achievable.

The following figures show the annual ordinary net income (after payment of operating expenses) as compared with interest requirements, and indicate the sufficiency or deficiency of net ordinary income:[435]

Fiscal year ended Feb. 28—	Interest paid and accrued	Ordinary net income (before income taxes)	Excess or deficiency of income over interest paid
1928	$284,000	$284,000	None
1929	302,000	330,000	$28,000
1930	296,000	353,000	57,000
1931	295,000	258,000	−37,000
1932	288,000	267,000	−21,000
1933	271,000	222,000	−49,000
1934	254,000	192,000	−62,000
1935	244,000	184,000	−60,000
	2,235,000	2,090,000	−144,000

Thus, from 1931 through February 1935, the regular net income of the investment trust was not sufficient to meet the aggregate interest requirements on all the outstanding debentures. The disparity between regular earnings and interest requirements was largely attributable to the capital structure which established fixed interest requirements upon the entire contributed capital and provided no paid-in equity to increase the earning capacity of the investment trust.

It has been indicated above that the debentures as a whole were not protected upon issuance by the presence of a capital contribution for equity securities. However, the $1,000,000 which was contributed by the sponsor for the "junior debentures" supplied a capital cushion for the $5,000,000 of "senior debentures" distributed to the public.[436] A decline of 16.7% in the assets of the investment company would eliminate this margin of safety of the senior debenture holders. The senior debentures as well as junior debentures were not secured by a pledge of collateral but constituted a general creditor claim on the company's assets. In view of the constant and often wide fluctuations in the prices of securities, a 16.7% decline was not improbable. There were numerous instances prior to the market break in 1929 wherein the Dow-Jones Industrial Stock Price Averages declined 10% to 20% within periods of a few days to a month. The severe declines in security prices in the period 1929 to 1933 are matters of com-

[435] Id., Pt. II, Exhibit A, Schedule 20–A.
[436] Id., Pt. II, Exhibit A.

mon knowledge, and are indicative of the inadequacy of the coverage originally supplied the senior debentures by the junior debenture capital in the Shawmut Bank Investment Trust.

In fact, Frederick A. Carroll, vice president and trust officer of the bank sponsor, suggested that a 20% margin was so insubstantial, due to the rapidity with which it could be eliminated in the administration of investment funds, that the bank considered it more desirable to invest $1,000,000, without any margin above that amount, in Shawmut Bank Investment Trust which it itself managed rather than subject that fund to another's management even though provided with a 20% margin. Mr. Carroll testified: [437]

> * * * If we had desired at any time during those days, we could have loaned a million dollars or a million and two hundred thousand dollars on collateral picked by somebody else, and that would have been regarded as a sound collateral loan.
>
> Now, the only difference between this and that was that there wasn't the 20 percent margin, but the handling of the million dollars by the Bank itself substantially, in the opinion of the officers, gave it as much protection as the 20 percent margin on the ordinary stock exchange security that might have been in the hands of some other person who had some other interests or some other loans that might have caught him in a spot which required him to sell precipitously, and it wouldn't take long for your 20 percent to go * * *

The declaration of trust expressly subordinated the payment of principal of the junior notes to the payment of principal and interest of the senior debentures.[438] However, the payment of interest on the junior notes was not expressly subordinated to the payment of interest on the senior debentures and the preservation of the principal of the senior debentures. The sponsor recognized such subordination in practice [439] although it was not mandatory under the specific terms of the declaration of trust or debenture. When questioned on this omission, Mr. Carroll testified that the subordination was read into the instrument by counsel for the trust: [440]

> Q. Will you admit, Mr. Carroll, that the indenture did not make that clear at all, and rather that it made the opposite clear?
>
> A. Well, I can't admit that exactly in view of the fact that that is what our counsel read into the indenture, as they read it, and they drew it.
>
> Q. Did that point arise during the operation of the Trust, so that you sought the opinion of counsel on that?

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[437] Op. cit. supra, note 431, at 3308.

[438] The provision governing the priority of the senior debentures over the junior notes is as follows (op. cit. supra, note 430, Pt. I, Exhibit A, Item 3 [pp. 12–13]):

> Junior Notes shall be subordinate to the Senior Debentures as herein provided. No payment shall be made of the principal of any of the Junior Notes unless all of the Senior Debentures, together with all accrued interest thereon, shall have been first paid in full; subject, however, to the right of the Trustees to call all or any part of the Junior Notes on any interest date or to purchase and retire any such notes, provided that the market value of the unpledged assets of the Trust as determined by the Trustees after the retirement of Junior Notes so called or purchased shall be at least 120 percent of the total amount of the indebtedness of the Trust, except such indebtedness as is expressly subordinate to the Senior Debentures.

[439] In February 1932, after the asset coverage for the senior debentures became impaired and income barely covered the interest charges of the senior debentures, payment of interest on the junior notes was postponed commencing March 1, 1932. In 1936, interest payments on the junior notes were resumed and interest arrearages were paid in full. (Op. cit. supra, note 430, Pt. IV, Item 27.)

[440] Op. cit. supra, note 431, at 3302–3.

A. Nothing as to any default on the seniors, but there was an interruption of the interest on the juniors, for a period from 1932 to 1935 during the depression, and in connection with that we had opinions in reference to the situation and the priority of the seniors to the juniors.

Q. You understand, I am not saying that you did prefer interest on the juniors to the seniors.

A. I understand. Your question is whether or not the indenture made the interest on the seniors prior to the juniors.

Q. That is right.

A. And our counsel said that the senior debentures, both as to principal and interest, were prior to any right of the juniors.

Q. Why was it necessary to go to counsel to find out about that?

A. I think any carefully managed trust would get the opinion of counsel before it takes any action in reference to a junior security.

Q. Wasn't it because the indenture wasn't precise on that point?

A. No; I think it is the practice to get counsel to pass on questions of that type, even though you may be a lawyer yourself.

The declaration of trust contained no terms governing procedure with respect to default in payment of interest or principal of the senior or junior debentures.[441] The senior debentures themselves contained a provision specifying a procedure upon the event of default in the payment of interest or in the observance of covenants. That provision reads as follows:[442]

In the event of the termination of the Trust prior to the date of maturity of any Senior Debentures then outstanding, or in the event of any default in the payment of any installment of interest on any of the Senior Debentures when and as the same shall become payable, or in the event of any default in the observance of any of the covenants, conditions, and agreements on the part of the Trust with respect to the Senior Debentures, and such default in either case shall continue for sixty (60) days after written notice thereof shall have been given to the Trust or to the Depositary and Registrar of the Trust by the holders of a majority in interest of Senior Debentures then outstanding, the principal of all the Senior Debentures, if not already due and payable, forthwith shall become and be immediately due and payable, anything herein or in the Declaration of Trust contained to the contrary notwithstanding.

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[441] Mr. Carroll testified (id., at 3299–3300):

Q. These debentures could have refused to or failed to pay interest at the prescribed time, and that was not a reason for default?

A. I wouldn't say that was exactly so, because any bondholder in Massachusetts can ask for a default to be declared in the event that there is a default in interest. While the instrument did not make that clear, I think as a matter of law in Massachusetts that is so.

Q. You mean to say it would have given rise to a cause of action, to sue for the interest unpaid?

A. Yes.

Q. Would it have accelerated the maturity of the bond issue?

A. I think that might be so as a matter of Massachusetts law.

Q. But not under——

A. The indenture.

Q. And isn't it also the Massachusetts law, or so I have been told, that the courts in Massachusetts pretty much stick literally to the terms in those indentures of Massachusetts trusts?

A. I think that is so generally, but I know that in this particular case the bondholder was not precluded from taking action in the event of continued default of interest.

Q. But it wasn't a legal safeguard given him under the terms of the bond as issued?

A. There was nothing in the indenture.

[442] Op. cit. supra, note 430, Exhibit Item 10 (b).

Only after a majority of the senior debenture holders gave written notice to Shawmut Bank Investment Trust or its depositary and registrar could a default by the investment trust in payment of interest or in observance of its covenants become the basis for declaring the principal of the debentures due. Since the National Shawmut Bank, as provided in the declaration of trust, was both depositary and registrar,[443] notice of default with respect to the senior debentures was required to be given to the investment trust or to its sponsor. The trustees of the investment trust were directors of National Shawmut Bank, and the appointment of successor trustees was subjected to the approval of the executive committee of the bank.[444] As has been indicated, the bank held the debentures that were subordinate to the senior debentures. Thus, any notice to the investment trust or to the bank sponsor concerning a default with respect to the senior debentures would have to be given to the defaulting trust itself or to the interests which controlled the trust and which, in addition, held junior claims against it. Debenture holders seeking to avail themselves of this provision might well be hampered by the possible adverse interests of the trustees of the investment trust [445] and the sponsor, particularly since no provision was made for a special trustee for the senior debenture holders who might serve as a conduit for their collective activity.

The only safeguards with respect to asset coverage were those which required 120% coverage in the value of the assets of the trust over the principal amount of senior debentures in the event that obligations were created by the investment trust having a priority or a parity with the senior debentures or in the event that junior debentures were redeemed or repurchased.[446] In this connection the market value of the assets of the investment company was to be left to the sole determination of the trustees.

While the contribution of the junior debentures served as a "cushion" for the senior debentures, the absence of any provision accelerating maturity of the senior debentures if the assets of the investment company fell below a fixed minimum ratio made it impossible to take advantage of the "cushion" when portfolio security values declined. In the period 1931 to 1935 the senior debentures were "under water," but the trust was not required to liquidate the assets and distribute the proceeds to the senior debenture holders.

Mr. Carroll, however, considered the lack of a "touch-off" clause particularly beneficial, since the trust was not compelled to undergo a forced liquidation: [447]

Looking at it from today's viewpoint, or from the viewpoint of today, it worked all right. Theoretically, it may be looked at askance, but it has worked out well, and the absence of some of the so-called protective provisions in a trust of this kind has been responsible for being able to return to the investor everything that he put in, plus a yield all during the depression and an appreciation to the common stock. If there had been some protective provisions in this particular

[443] Id., Exhibit A (p. 16).

[444] Id., Item 21.

[445] Under the Trust Indenture Act of 1939 it would seem that the trustees for the investment trust would not qualify as trustees for the debenture holders due to the existence of conflicting interests (Trust Indenture Act of 1939, Sec. 310b).

[446] Op. cit. supra, note 430, Exhibit A (pp. 12–13).

[447] Op. cit. supra, note 431, at 3336.

Trust it might have been necessary to sell at a given point, which would have pegged the failure of the Trust.

It must be observed, however, that had a liquidation pursuant to a "touch-off" clause occurred the equity interest of the sponsor would have been eliminated entirely, or if some part were salvaged it would have lost all leverage. Under the existing situation, the sponsor was enabled to pursue a waiting policy at a time when the senior debentures were "under water" and rapidly sinking. In Mr. Carroll's words:

> * * * we knew we didn't have to sell, no matter what happened; that our collateral loans [the junior notes], starting off with the 100 percent collateral, weren't subject to the various difficulties that might be occasioned if in the hands of an individual, and that we could carry along and hold our position—and we did so, and there has been no loss, and there has been a fine yield during the depression.[448]

Although the senior debentures were not protected by any reserves or funds for redemption nor by any "touch-off" provisions which might have assured the return to the senior investor of the principal amount of his capital contributions, it may be observed that the investment trust purchased and retired approximately one-fifth of the senior debentures.[449] The investment trust thus did return capital to the senior debenture holders but it returned only a fraction of the original contribution of these investors, since repurchases were made at less than the face value. From 1931 to the beginning of 1935, during which period the senior debentures were almost constantly "under water" and the junior notes for the most part were without any asset value, the investment trust repurchased $1,099,000 principal amount of senior debentures at an aggregate discount of $404,145.[450] These repurchases were not only at prices below face value but also below asset value,[451] so that the profits of the repurchase program ultimately inured to the benefit of the junior notes when they regained asset value in 1935.[452]

b. Central States Electric Corporation

In the absence of adequate provisions accelerating the maturity of debentures, the holders of this type of security are unable to take any action even though the assets of the investment company have declined to a point below the principal amount of the debentures and

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[448] Id., at 3308–9.

[449] Id., at 4430.

[450] Op. cit. supra, note 430, Pt. V, Table 16, and Pt. IV, Table 7A.

[451] Ibid.

[452] Mr. Carroll agreed that this purchase of $1,099,000 principal amount of debentures redounded to the benefit of the equity security holder (op. cit. supra, note 431, at 3340–1):

Q. You spoke about the retirement of some of these senior debentures, something over $1,000,000.
A. Yes.
Q. Approximately what did those cost the trust? Were they retired at par, or a premium, or something less than the principal?
A. They were retired at less than par. We never went out in the market and chased them. We bought them if they were offered, and the price at times was much less than par. I think on one or two occasions we asked for tenders and took the lowest tender.
Q. Do you count the difference between par and purchase price as profit?
A. I suppose it must have entered into the books in some way as that.
Q. At any rate, it adds to the book value of the common stock, doesn't it?
A. Yes; eventually it would; by reducing the debt prior to it.
Q. Reducing the debt to less than the principal amount, the difference——
A. The difference would accrue to the equity holder.

the earnings are insufficient to cover the current interest on the debentures. The company may pay current interest on the debentures out of capital. Despite the impairment of senior capital, so long as the company pays the current interest, the holders of the junior securities can retain the management of the company while the debenture holders are powerless either to take over the management or to effect liquidation and thus escape any possible further losses.

Central States Electric Corporation issued two series of debentures in the aggregate principal amount of $45,000,000.[453] The 5% convertible debentures, series due 1948, were issued in January 1928 in the principal amount of $20,000,000.[454] The optional 5½% debentures, series due 1954, were issued in the principal amount of $25,000,000 in September 1929.[455]

The debentures were entirely unsecured.[456] Such protective measures as were contained in the several indentures pursuant to which these senior securities were issued related to various restrictions in the creation by Central States Electric Corporation of prior claims on the assets of the investment company and in the issuance of additional debentures or obligations of the investment company, and the payment of dividends on junior securities unless the net assets of the investment company were equal to a certain percentage of the outstanding debentures.[457] No "touch-off" provision existed, nor was there any prohibition against the payment of interest to debenture holders out of capital even if that capital should be insufficient to cover the principal amount of the debentures outstanding.

Concerning the lack of a "touch-off" provision, James Forrestal, vice president of Dillon, Read & Co., which underwrote the Central States Electric Corporation debentures, testified:[458]

Q. Now let me ask you a few more questions about these debentures. There is no protection here to the public in case the debentures go "under water" as they subsequently did?

A. None.

Q. None at all?

A. By that you mean there is no arbitrary point at which they have to mature?

Q. I mean the assets of the company can sink to zero and the bonds cannot be called until twenty years hence.

A. That is correct.

Q. They cannot be called for twenty years?

A. No.

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[453] For a description of the securities issued by Central States Electric Corporation, see supra, pp. 1683–1707.

[454] Reply to the Commission's questionnaire for Central States Electric Corporation, Pt. II, Exhibit A, Schedule 16d. The company realized net proceeds of $18,600,000 from the issuance of these debentures pursuant to an agreement between the investment company and Dillon, Read & Co. as manager of the purchasing syndicate (ibid.).

[455] Id., Schedule 16e. The investment company realized $23,562,500 from the issuance of these debentures pursuant to an agreement between the investment company and Dillon, Read & Co. as manager of the purchasing syndicate.

[456] Id., Pt. I, Item 11, Exhibits 41, 42, 43, and 44.

[457] The 5% debentures, Series due 1954, were only accorded the provision prohibiting the creation of prior claims on the assets of the investment company (id., Exhibit 44 [pp. 15–16]).

[458] Public Examination, Central States Electric Corporation, at 12904.

Q. No matter how low the assets go?

A. That is right.

When the debentures were offered to the public, the assets of Central States Electric Corporation greatly exceeded the principal amount of the debentures. The offering circular of the optional 5½% debentures gave the value of the assets of the investment company as at August 31, 1929, adjusted to include the prospective proceeds from the funded debt, at upwards of $350,000,000.[459] Net earnings of the company, prior to the payment of interest, for the 12-months' period ending August 31, 1929, were stated to be over $19,000,000.[460] Thus, the debentures of this investment company were issued with a cushion of assets of more than $300,000,000 and a margin of earnings over the required fixed interest charges[461] amounting to approximately $17,000,000.[462]

After 1929, the asset value of Central States Electric Corporation suffered an enormous shrinkage. The net assets of the investment company declined from $350,000,000, at the time of the issuance of the second series of debentures, to $40,600,000 at the end of 1931, at which time and for the next two years the assets at market exceeded the principal amount of debentures outstanding by only a small margin. In 1933, the debenture went "under water," that is, the face value of the outstanding debentures exceeded the net value of the investment company. These debentures remained "under water" in 1934 and during the major part of 1935. At the end of 1935 and during 1936 the assets of the company at market again covered the debentures, but in 1937 the debentures once more went "under water" and have remained in that condition. At the end of June 1939, the company had only approximately $12,000,000 of assets for $27,479,000 principal amount of debentures. The amount of debentures outstanding and the asset coverage by years are given below:[463]

Year-end	Principal amount of debentures outstanding	Liquidating value of assets at market	Excess or (deficiency)
1929	$43, 250, 000	$147, 658, 587	$104, 378, 587
1930	42, 570, 000	79, 620, 725	37, 050, 725
1931	39, 919, 000	40, 601, 973	682, 973
1932	38, 558, 000	40, 798, 041	2, 240, 041
1933	37, 855, 000	23, 271, 766	(14, 583, 234)
1934	37, 696, 000	18, 321, 193	(19, 374, 807)
1935	37, 193, 000	38, 116, 239	923, 239
1936	36, 904, 000	40, 904, 003	4, 000, 003
1937	36, 520, 000	20, 792, 231	(15, 727, 769)
1938	27, 727, 000	16, 856, 597	(10, 870, 403)
1939 [a]	27, 479, 000	11, 808, 018	(15, 670, 982)

[a] First 6 months.

[459] Id., Item 9, Exhibit 31.

[460] Ibid.

[461] The interest on funded debt was stated to be $2,341,300 (ibid.).

[462] It is to be noted that $12,000,000 of income was derived from stock dividends declared by an affiliated corporation and $7,600,000 from profit on the sale of securities. Only $800,000 was derived from cash dividends and interest (ibid.).

[463] Id., Pt. I, Item 8, and derived from supplementary information supplied the Commission for Central States Electric Corporation.

Concurrently with the severe declines in the asset value of Central States Electric Corporation, its net earnings diminished rapidly after 1929. The annual net earnings before interest and for the period from 1929 to June 1939, together with the interest paid on the debentures and the excess or deficiency, are shown below:[464]

Year	Net income (loss) before interest on funded debt [a]	Interest on funded debt	Excess or (deficiency) of net income
1929	$18,930,356	$1,335,534	$17,594,822
1930	4,687,129	2,274,997	2,412,132
1931	(4,731,159)	2,194,835	(6,925,994)
1932	(3,152,603)	2,072,943	(5,225,546)
1933	(9,179,559)	2,019,165	(11,198,724)
1934	(5,467,535)	2,005,370	(7,472,905)
1935	(16,265,177)	1,985,290	(18,250,467)
1936	788,913	1,967,496	(1,178,583)
1937	1,599,873	1,952,148	(352,275)
1938	(83,188)	1,895,496	(1,978,684)
1939 [b]	59,568	733,749	(674,181)
Total	(12,813,382)	20,437,023	(33,250,405)

[a] This item includes realized gains or losses on sales of securities but does not include profits from repurchase and investment of debentures. The net income reported for 1929 and 1930 includes net valuations placed on stock dividends received amounting to $10,871,186 for 1929 and $6,343,252 for 1930.

[b] First 6 months.

From 1931 to June 1939 the net income of Central States Electric Corporation was consistently and substantially less than the interest paid on the debentures.[465] The book deficit of the investment company steadily mounted until it reached a peak of $24,904,681 in June 1939.[466] This deficit was attributable in large measure to the interest requirements of the investment company's funded debt which aggregated $20,437,023 in the period from 1929 to June 1939.[467]

The failure of current income to meet interest requirements meant that a portion of the interest charges had to be paid out of capital or surplus. Although on its books Central States Electric Corporation had a surplus up to 1933, if unrealized appreciation be eliminated

[464] Derived from annual and interim reports to stockholders by Central States Electric Corporation.

[465] Ibid. Through the year 1933 stock dividends of The North American Company comprised the most substantial part of the income of Central States Electric Corporation. Taken in on the basis of the market value of the shares of stock at the time when received, almost invariably the value of stock dividends was required to be reduced in accordance with depreciated value at the end of the fiscal year (ibid.).

[466] Ibid.

[467] Ibid. Losses from the sale of securities accounted for most of the remainder of the company's deficit (ibid.).

from this surplus, the company had no surplus after 1929.[468] In actuality, therefore, after 1930 interest on the debentures was paid largely out of the capital of the investment company. When considered with the fact that the debentures were "under water" from 1933 to the middle of 1935 and from 1937 to June 1939, it may be said that in substance interest was paid to a substantial degree in these years out of the debenture holders' capital contributions. In effect, most of the interest paid to debenture holders during these periods was no more than the return of their capital.

The maintenance of interest payments, although accomplished in large measure through a return of capital, effectively barred the debenture holders from securing acceleration of the maturity of their debentures. Thus, in the absence of a provision enabling the debenture holders to act upon the impairment of the asset coverage for the principal of their debentures, the assets of the company might decline in value to a small fraction of the principal amount of debentures and earnings might shrink drastically, with the debenture holders impotent to realize upon the existing assets of the company at any time they considered it advisable.

Mr. Forrestal conceded that debenture holders had no means to recover any part of the assets of the investment company prior to the stated maturity no matter how low the asset coverage for the debentures might fall:[469]

Q. * * * So there was no protection to the debenture holders in case the assets fell below the amount of the obligation?

A. Well, he had a protection, the protection of what assets were in the company that were available for debentures. But as you say, there were no touch-off clauses that lit the match that enabled him to get at them immediately.

Q. He had to hang on?

A. That is right.

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[468] The book surplus or deficit and the unrealized appreciation or depreciation were as follows:

Year	Surplus or (deficit)	Unrealized appreciation or (depreciation)
1929	$18,483,746	$45,290,199
1930	15,218,880	(19,996,775)
1931	13,497,619	(49,551,585)
1932	8,863,578	(43,751,333)
1933	4,320,117	(49,960,796)
1934	(3,145,782)	(47,458,121)
1935	(21,396,238)	(9,252,767)
1936	(22,075,660)	(5,061,666)
1937	(22,424,895)	(24,653,288)
1938	(24,398,056)	(18,377,903)
1939 (to June 30)	(24,904,681)	(22,671,854)

[469] Public Examination, Central States Electric Corporation, at 12651.

Q. That is not callable for 20 years.

A. You mean it could run for 20 years?

Q. Yes.

A. That is right.

Q. So, so far as the common stock is concerned, they borrowed this $20,000,000, and it is noncallable——

A. I know what you mean, it could not be brought to maturity.

Q. If you borrow from a bank, you can be sold out.

A. That is right.

Q. If your collateral falls below the point.

A. That is right.

Q. And here the common stock could never be sold out.

A. That is right.

While agreeing that the absence of a touch-off clause handicapped the debenture holders in the respect mentioned above, Mr. Forrestal urged, nevertheless, that the presence of such a provision was fraught with dangers both to the investment company and to bond or debenture holders which outweighed its advantages. He testified: [470]

Q. Don't you, as a banker, think that the investing public is entitled to some protection of that sort?

A. Well, I think if you had a security——

Q. You have a duty to your customers, don't you?

A. Personally, I am always against any such clauses, because I think they may bring about a forced liquidation at a time when it shouldn't be brought about.

Q. That depends on how it is written, doesn't it?

A. It is pretty difficult to escape that happening, if it is to be in at all. I think you make your investment on the general credit of the man you loan money to.

Q. So you are satisfied that your customers ought to lend money to the company on debentures, no matter how far down it goes, and not have any protection?

A. I think it is a better form of financing, always.

Q. From the company's point of view.

A. No, from both.

Q. From the individual's point of view, if you have a touch-off clause, he gets paid off 100 percent——

A. Oh, but he doesn't. He may be touched off in a market where he is subjected to a greater sacrifice. I have never yet seen one that worked effectively.

Q. I have.

A. I haven't. I have seen a lot of harm come from the application the other way.

Q. I have seen it work for the protection of investors. It wouldn't be very hard in this case—I mean, you could see your assets, so that in this case the investor would at least have gotten 90 cents on the dollar, whereas at the end of 1934 he only got 50 cents on the dollar.

A. Well, he might. We have seen many cases in the bank where they had a touch-off on the assets. What happens? They get the assets, the market is so depreciated they can't possibly sell to anybody. And it is known that

[470] Id., at 12652–3.

they are available to sell; that that collateral is there; and it depreciates that collateral in the minds of possible buyers.

While a forced liquidation may at times result in a failure to procure sufficient cash to pay bond or debenture holders in full, it is nevertheless clear that the continued operation of the company is almost entirely at the risk of the debenture holders. The history of the Central States Electric Corporation debentures illustrates this situation. The debentures, which had asset coverage of 50% at the end of 1934, had obtained a coverage of 110% at the end of 1936. However, in the succeeding year the debentures were once more "under water," continued in this condition for two and one-half years, and by June 30, 1939, the assets at market value were sufficient to cover only 43% of the face amount of outstanding debentures.[471] The debenture holders were, of course, unable to benefit—to secure liquidation—from the transient recovery in asset coverage in 1935 and 1936. Gross income for the 6-month period ending June 30, 1939, according to the interim report of the company, was only 30% of interest requirements.[472]

Practically from the time when the first series of debentures discussed above was issued by Central States Electric Corporation, the company engaged in the practice of repurchasing its debentures.[473] In fact, in the 12-month period preceding the issuance of the second series of debentures in principal amount of $25,000,000 in September 1929, the investment company had repurchased approximately $1,000,000 of the first issue of debentures at a substantial discount from face value. By June 1939 the investment company had reacquired $17,521,000 principal amount of debentures at a cost of approximately $7,343,000.[474] These repurchases have been made in general at prices considerably below current asset values. The debenture holders who have sold their debentures have received not merely less than the principal amount of their debentures but less than the asset value of their debentures. This has resulted in a shifting of asset value to remaining debentures holders, and should there occur a substantial

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[471] Derived from supplementary information supplied the Commission for Central States Electric Corporation.

[472] Ibid. It is interesting to note a problem that may confront the directors of the investment company, due to the fact that the two issues of debentures mature in different years—1948 and 1954. When the 1948 debentures mature, the company's assets may be sufficient to pay only these debentures in full. The 1954 debentures may receive little, if anything, six years later. At June 1939 the face value of 1948 debentures was $9,853,000 and that of the 1954 debentures was $17,626,000. Asset value of the company was $11,808,018 (ibid.).

[473] It may be noted that the 5% convertible debentures, series due 1948, had provision for a purchase fund pursuant to which the investment company was obliged to make available the sum of $200,000 annually for the purchase and retirement of debentures. The price at which debentures were to be purchased by the "purchase fund agent" was to be at or below the principal amount thereof. There was no such provision for the 5½% optional debentures, series due 1954 (reply to the Commission's questionnaire for Central States Electric Corporation, Pt. V, Item 34).

[474] At June 30, 1939, there was $27,479,000 principal amount of debentures outstanding of the original issue of $45,000,000. The principal amount of $750,000 was reacquired through conversion into preferred stock by the debenture holders (reply to the Commission's questionnaire for Central States Electric Corporation, Pt. II, Exhibit A, Schedule 18c). The principal amount of $8,191,000 was reacquired through exchange of North American Company common stock valued at $2,906,014 (derived from supplementary information supplied the Commission for Central States Electrical Corporation). The principal amount of $8,580,000 was reacquired at a cost of $4,436,921 (ibid.).

recovery, the discount would rebound to the advantage of the common stockholders. Actually the gradual liquidation of working capital through the payment of interest and the repurchases has been greatly narrowing the possibility of a recovery not only for the stock but for the debentures.

2. THE INEFFECTIVENESS OF PROTECTIVE CLAUSES TO SAFEGUARD BOND AND DEBENTURE HOLDERS

A "touch-off" clause, which purports to secure at least a specified minimum of coverage for the bonded indebtedness, has generally been regarded as a vital safeguard to the bondholder. It is clear, however, that the significance of such a clause depends almost entirely upon what provision is made in the indenture for the immediate and accurate detection of the relationship of net assets to the amount of bonded indebtedness, the nature of the rights which the bondholders acquire if the "touch-off" point is reached, and the provisions for the expeditious enforcement of those rights.

It may be said generally that the majority of investment companies which did include a "touch-off" provision in the indenture rendered the "touch-off" clause ineffectual by failing to introduce sufficiently definite criteria with respect to the elements of the covenant and by failing to impose upon the trustee any responsibility in connection with the ascertainment of compliance or any standard of accountability to bondholders for abstaining from enforcing a default.

The failure on the part of the obligor to provide a trustee charged with the protection and the enforcement of the rights of the bondholders has recently received legislative attention in the Trust Indenture Act of 1939. Under this Act such trust indentures as come within the registration requirements of the Securities Act of 1933[475] must now contain provisions requiring the obligor to file with the indenture trustee and with the Commission such information, documents, and reports with respect to compliance with the conditions and covenants provided in the indenture as may be prescribed by the Commission pursuant to rules and regulations and authorizing the Commission to require, in the case of annual reports, certificates or opinions of independent public accountants as to such compliance.[476] The indenture to be qualified must contain a further provision requiring the obligor to transmit to the indenture security holders such summaries of these reports as may be prescribed by the Commission.[477] The obligor is required to furnish to the trustee, bondholders' lists to which the trustee must yield access upon the request of three or more indenture security holders or mail to the other bondholders such communications as the applicants forward for transmission unless its opinion that such mailing would be contrary to the law or the best interests of the indenture security holders is sustained by the Commission.[478] The trustee, under the qualifying indentures, will be required to give to the security holders notice of all defaults known to the trustee within 90 days of the

[475] As well as indentures which cover securities issued in connection with voluntary or judicial reorganizations which are exempt from registration under the Securities Act of 1933.

[476] Trust Indenture Act of 1939, Section 314 (a) (I), (II).

[477] Id., Section 314 (a) (III).

[478] Id., Section 312.

occurrence thereof, but the indenture may permit the trustee, in the case of any but two specified types of default [479] to withhold notice when the trustee in good faith determines such withholding to be in the best interests of the indenture security holders.[480] After the occurrence of a default (as this term is defined in the particular indenture) the trustee, in the matter of the exercise of such rights and powers as are granted it in the indenture, is held accountable for the degree of care and skill of a prudent man in the conduct of his own affairs.[481]

The indenture may authorize the trustee conclusively to rely upon certificates or opinions conforming to the requirements of the indenture, but the indenture must contain provisions requiring the indenture trustee to examine the evidence furnished to it to determine whether or not such evidence conforms to the requirements of the indenture.[482] The act prohibits the inclusion in the indenture of clauses exempting the trustee from liability for its own negligence except that the latter's responsibility for the period before default may be limited to the performance of such duties as are specifically set out in the indenture and the trustee may be protected from liability for any error of judgment in good faith unless it should be proved that the trustee was negligent in ascertaining the pertinent facts.[483]

These are, of course, only a few of the provisions of the Act but they, together with the section disqualifying trustees having conflicting interests,[484] appear to be the provisions most relevant to the unsecured debentures usually issued by investment companies.[485]

It would appear that when the appropriate implementing rules are established by the Commission, it may be difficult for the trustees of investment company debentures to be as oblivious of the occurrence of defaults and the violation of covenants, specified in the indenture, as they have been in the past. Nevertheless, it must be recognized that the Trust Indenture Act undertakes only to exact from the obligor a certain amount of disclosure and from the trustee a larger measure of enforcement accountability in connection with whatever covenants happen to be clearly enunciated in the indenture—the Act does not require the inclusion in the indenture of any substantive provisions essential in the protection of the interests of the holders of debentures of investment companies. Thus, when an indenture fails to provide for a sinking fund or to contain a "touch-off" provision or a provision conditioning the issuance of additional debentures upon the existence of a certain ratio of assets to funded debt, the trustee, even under the Act, is unable to ameliorate the unprotected status of the investor. Moreover, when the ostensible protective provision lacks definiteness, contains ambiguous criteria, or is open to a

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[479] In the case of default in the payment of the principal of or interest on any indenture security, or in the payment of any sinking or purchase fund installment, the indenture may not grant the trustee protection in withholding notice (id., Section 315 (b)).

[480] Id., Section 315 (b).

[481] Id., Section 315 (c).

[482] Id., Section 315 (a).

[483] Id., Section 315 (a), (b).

[484] Id., Section 310.

[485] The Act contains numerous important provisions in connection with the recording of indentures, the release and substitution of property, and the submission of certificates of fair value, which relate to obligations secured by the mortgage or pledge of specific property and hence are not applicable to the majority of debentures of investment companies which are not collateralized in this manner.

variety of possible interpretations, the Act is not designed to secure for the investor a more certain or rigorous application of the safeguard.

A bondholder of an investment company, who finds in the bond indenture a covenant on the part of the company to redeem all the then outstanding debentures if the net assets of the company should fall below a specified ratio to the funded indebtedness, will no doubt be inclined to assume that here he has a strong, unequivocal safeguard. A more intensive examination of the indenture would be likely, however, to reveal that the terms employed are so ill defined and nebulous and the provisions for enforcement so lax and inadequate that the protection afforded the bondholder is more nominal than real.

The history of the "touch-off" provision in the case of Reynolds Investing Company, Inc., illustrates how such an ostensible protection may be divested of significance through the equivocal character of its criteria and by the difficulties in the way of securing the enforcement of the remedial features.[486] The latter situation may be partly cured, hereafter, in connection with such indentures as come within the scope of the Trust Indenture Act of 1939.

a. Reynolds Investing Company, Inc.

Reynolds Investing Company, Inc., an investment company of the general management type, organized in Delaware in March 1928,[487] subsequently issued to the public an aggregate $5,000,000 of 20-year 5% Gold Debentures under an indenture containing a "touch-off" clause fairly typical of those current in the investment company field. The "touch-off" clause read as follows:[488]

> ARTICLE III, SECTION 8. The Company covenants that if at any time during the life of this indenture its net assets (before deducting its funded debt) shall be less than one hundred and ten percent (110%) of the funded debt of the company, it will redeem all the then outstanding Debentures at the next semi-annual interest-payment date on which redemption may be made, in accordance with the provisions of Article II hereof and/or applicable redemption provisions of any supplemental indenture.

Article II, referred to in the "touch-off" provision, provided that the redemption of debentures should be at the rate of 103 percent of the principal thereof up to and including April 1, 1931, and at the rate of 100 percent of the principal thereafter, with accrued interest in each case.[489]

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[486] Another example of the difficulties created by the ambiguity of a "touch off" provision will be found in the case of Reliance Management Corporation set forth infra, pp. 1834–42.

Additional illustrations of the lack of activity of trustees in the face of the infringement or the approaching infringement upon the "touch off" clause may be noted in the cases of International Securities Corporation of America and Eastern Utilities Investing Corporation related infra, pp. 1844–58, in connection with the subject of repurchases of bonds.

[487] Reply to the Commission's questionnaire for Reynolds Investing Company, Inc., Pt. I, Exhibit A. Details of the organization and the financing of the company through common stock, cumulative preferred stock, and bonds will be found in Ch. II of this part of the report, pp. 350–496.

[488] Reply to the Commission's questionnaire for Reynolds Investing Company, Inc., Pt. I, Exhibit I. The indenture named The Seaboard National Bank of the City of New York as trustee.

[489] Id., Pt. I, Exhibit I, Art. II.

Thus by Article III, Section 8, the Company undertook to liquidate the Debentures at one hundred and three percent of the principal prior to April 1, 1931, and at one hundred percent (100%) of the principal thereafter, together with accrued interest, should the net assets fall below one hundred and ten percent (110%) of the amount of funded indebtedness. But if the latter contingency actually and undeniably occurred, there was, nevertheless, no assurance that the bondholder would receive the promised distribution. The failure of the company (the management and directors) to make the promised distribution would merely constitute a default. The trustee might then proceed to turn the default into an "event of default" by serving a "written notice of such default requiring the Company to comply with the covenants or agreement in respect of which it is so in default."[490] This notice the trustee might serve "in its discretion or at the request in writing of the holders of twenty-five percent (25%) in principal amount of the Debentures then outstanding."[491] If within sixty days after the receipt of such written notice the Company failed to remedy the default—in this case to redeem the outstanding Debentures—an "event of default" arose.[492]

The maturing of an "event of default" was not tantamount to the obtaining by a bondholder of the relief covenanted by the Company in the "touch-off" clause. Unless requested to act, in writing, by the holders of twenty-five percent (25%) in principal amount of all debentures, the Trustee need do nothing and then apparently there was a standstill. Upon receipt of a written request from the holders of twenty-five percent (25%) in principal amount of debentures, the Trustee could be moved to make a "declaration of default"—declare the principal and interest of the debentures immediately due and payable.[493]

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[490] Id., Pt. I, Exhibit I, Art. V, Sec. 2.

[491] Ibid.

[492] Ibid. The circumstances under which an "event of default" arose are set forth in the Indenture as follows:

> SECTION 2. In case one or more of the following events, herein termed "Events of Default," shall happen; that is to say, in case—
>
> * * * * * * *
>
> (c) Default shall be made in the observance of any of the covenants on the part of the company in the Debentures or in this indenture expressed, and the Company shall not remedy such default within sixty (60) days after written notice of such default requiring the Company to comply with the covenants or agreements in respect of which it is so in default, shall have been served upon the Company by the Trustee, which may either in its discretion or at the request in writing of the holders of twenty-five percent (25%) in principal amount of the Debentures then outstanding give such notice. * * *

[493] Ibid. The Trustee could, in his own discretion without the solicitation of the debenture holders make a "declaration of default." Section 2 of the Indenture provides that after the maturing of an "event of default":

> then the Trustee in its discretion may, and upon request in writing by the holders of twenty-five percent (25%) in principal amount of all Debentures issued hereunder then outstanding shall, declare the principal of all the debentures if not already due to be forthwith due and payable, and upon such declaration (hereinafter called "Declaration of Default"), the Debentures, together with the interest thereon and interest at the rate of six percent (6%) per annum on overdue principal and interest, shall become due and payable immediately, anything in this indenture or in said Debentures contained to the contrary notwithstanding.

Section 1 (f) of Article VII of the Indenture creates some doubt as to whether the Trustee was compelled to make a "declaration of default" even when requested by the specified proportion of debenture holders:

> (f) Unless and until the Trustee shall have received written notice to the contrary from the holders of not less than twenty-five percent (25%) in amount of the Debentures outstanding, the Trustee may conclusively assume for the purposes of this indenture

If, now, the Company "should fail within a reasonable time to comply with the demand of the Trustee to pay to it a sum * * * sufficient in amount to cover all overdue principal and interest" then the Trustee "shall be entitled and empowered to protect the rights of the Debenture holders under this indenture by action at law or suit in equity."[494] However, the Trustee need not proceed with a prosecution of any action or suit or in fact with the exercise of any of the powers or trusts of the Indenture unless the holders of twenty-five percent (25%) of the principal amount of the Debentures have notified it of the default and of the continuance thereof, have requested it to act, and have offered it satisfactory indemnity against cost, expenses, and possible liabilities.[495]

The above is a short résumé of the difficulties facing the bondholders under this and similar indentures in securing the promised relief even if the "touch-off" point had admittedly been reached. A still greater obstacle consisted of the practical inability of the bondholders to secure either proof or admission that the "touch-off" point had as a matter of fact been reached.

While the Trustee, by the Indenture, was given the right to inspect the books of the Company "at all reasonable times," the Indenture specifically provided that a certificate by the president or any of the other enumerated officers of the corporation might serve as conclusive evidence of the present or past existence of any fact which it might be necessary or expedient for the Trustee to ascertain under the Indenture and that the Trustee "shall be fully justified in acting thereon."[496] The Indenture further provided that the Trustee be protected in acting on any such certificate, affidavit, statement, or resolution and that the Trustee incurred no liability for any action taken by it in reliance upon such certificate or resolution properly certified.[497]

It thus appears that the Trustee was not encouraged to make any independent investigation of important facts and was practically directed to accept the version tendered by the management.

In connection with the "touch-off" clause, the fact as to what the "net assets" of the Company were at any given time was the most vital element. Were the term "net assets" so clearly defined in the instrument as not to permit evasion or selective interpretation, the manage-

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that there has been no Event of Default hereunder. The Trustee shall not be required to take any action in respect of any such default unless requested so to do by an instrument in writing or concurrent instruments in writing signed by the holders of not less than twenty-five percent (25%) in amount of the Debentures outstanding, and tendered security and indemnity satisfactory to it against any and all costs, expense, and liability, anything herein contained to the contrary notwithstanding, but neither any such notice or request nor this provision therefor shall limit any discretion therein given to the Trustee or which it may otherwise have to determine whether or not it will take action with respect to any such default or whether or not it shall take action without such request or indemnity.

[494] Id., Pt. I, Exhibit I, Art. V, Sec. 3.

[495] Id., Pt. I, Exhibit I, Art. V, Sec. 6.

[496] Id., Pt. I, Exhibit I, Art. VI.

METHODS OF PROOF.—Whenever it shall be necessary for the Trustee under this indenture to ascertain the present or past existence of any fact, or the Trustee shall deem it expedient so to do, and the method of conclusively proving such fact to the Trustee shall not have been otherwise provided for by the terms of this indenture, then and in every such case the Trustee may receive as conclusive evidence of the present or past existence of such fact, and shall be fully justified in acting thereon, a certificate setting forth such fact made by the president or a vice president and by the secretary or an assistant secretary of the Company over the corporate seal of the Company.

[497] Id., Pt. I, Exhibit I, Art. VII, Sec. 1 (g) (i).

ment might have had no alternative but to disclose that "net assets" totaled less than one hundred and ten percent (110%) of the funded indebtedness. However, the "touch-off" clause itself contained no criteria as to how the net assets of the Company were to be determined. Article III, Section 7, provided that the "net assets of the Company shall be determined in accordance with good accounting practice" but failed to define what "good accounting practice" was or how that was to be determined. This phrase was so ambiguous that the Company by accepting an interpretation thereof, tendered by its accountants and legal counsel, was able to prepare a statement indicating that the "touch-off" point had not been reached, whereas under a more generally acceptable interpretation, the "net assets" would have clearly been disclosed as less than the amount required by the "touch-off" provision. Moreover, the lack of definition enabled the management of Reynolds Investing Company, Inc. to assign appraised values to certain securities in the portfolio greater than the managements of affiliated companies assigned to the same securities at approximately the same time, the higher evaluation in the former case raising the assets above the specified "touch-off" point.

The investment company disclaimed that the "touch-off" point of one hundred and ten percent (110%) was ever reached. According to the reply to the Commission's questionnaire, the low point in asset coverage occurred on June 30, 1932, when the net assets amounted to 111.25% of the funded debt.[498] The asset coverage of the debentures for month ends in 1932, as reported by the Company, follows: [499]

Date:	*Percent coverage of debentures—net asset value*
December 31, 1931	125.03
March 31, 1932	124.57
June 30, 1932	111.25
September 30, 1932	145.33
December 31, 1932	123.36

More than 3½ years after the date of the Indenture (April 1, 1928), and approximately two months prior to the issuance of the year-end statement of 1931, at which time the net asset value of the debentures was reported to be one hundred and twenty-five percent (125%),[500] the board of directors sought a legal interpretation of the term "good accounting practice."

Counsel advised the Company that—

the determination of the net assets of your Company in accordance with good accounting practice, within the meaning of the applicable clauses of the Trust

[498] Id., Pt. IV, Tables 7 and 7A.

[499] Ibid. For the same period, the preferred stock, which had a liquidation value of $110 and a stated value of $100 per share, had a net asset value as follows (ibid.):

Preferred stock

Date:	*Net asset value per share*
December 31, 1931	$23.59
March 31, 1932	31.29
June 30, 1932	14.10
September 30, 1932	56.50
December 31, 1932	14.00

[500] Id., Pt. IV, Table 7A.

Indenture, may be made as follows: (1) Securities which have an active market value—by taking such market value as of the date under consideration; (2) Securities which have no active market values but which have not shrunk in intrinsic worth—by taking the cost to you; (3) Securities which have no active market values but which have shrunk in intrinsic worth—by taking the appraised values as of the date under consideration.[501]

The most significant element of this legal opinion was that it permitted the Company to make its own appraisals of the asset value not only of such securities as had no market at all, but of such as the Company might choose to regard as having no "active market value."

The Company itself, in its inquiry of the attorneys, had taken the definite stand that some of its portfolio securities, though listed on exchanges and traded, had no market value because not "sufficiently actively traded in."[502] The opinion of counsel, however, did not undertake to define what an "active market value" was as distinguished from an "inactive market value."

The reply of counsel contained the suggestion that to the extent that appraisals were used, the management would be practically the arbiter of the net asset value of the Company.

An appraisal of the value of such securities under such circumstances is, of course, nothing more than an expression of opinion on such value. But if the appraisal is made by one or more persons who by training and experience are qualified to express such an opinion, who have acted in good faith, and have made the appraisal after consideration of all reasonably available information on the intrinsic worth of the securities under examination, including balance sheets and income accounts, past and present, the value arrived at can be attacked and set aside only by proof of error in fact on the part of the appraisers. Otherwise, an appraisal by any other equally qualified person which arrives at a different value amounts to nothing more than a difference of opinion.

The Company, pursuant to the advice of counsel, proceeded to appraise not only such securities as were not listed on exchanges, but also securities which it claimed had no "active market value."

Among the securities to which the Company assigned appraised values were two which were traded on an exchange. It will be shown that had the Company accepted the market prices in these two instances alone, instead of crediting itself with the higher appraisal values, the net assets of the Company would have been exposed as below the "touch-off" point.

Accepting the appraisal figures, the net assets of the Company would be compiled as follows from the balance sheet for December 31, 1931.[503]

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[501] Letter of November 4, 1931, from Cadwalader, Wickersham & Taft to Reynolds Investing Company, Inc.

[502] The Company's inquiry is reproduced in the opinion of counsel contained in the letter dated November 4, 1931.

[503] Reply to the Commission's questionnaire for Reynolds Investing Company, Inc., Pt. I, Exhibit E–6.

ASSETS		CURRENT LIABILITIES	
Cash	$35,310.62	Accrued interest payable on debentures	$45,877.50
Accrued interest and dividends receivable	22,075.31	Sundry accounts payable	10,460.68
Notes receivable	226,958.37	Reserve for State taxes	5,075.00
Investments [a] Total market and/or value as appraised by the Company.	4,365,970.05		
Deferred charges.[b]			
Total assets	4,650,314.35	Total current liabilities	61,413.18
Total liabilities	61,413.18		
Net assets	4,588,901.17		

[a] Investments *at cost* totaled $14,674,528.84.

[b] The balance sheet carried two "Deferred charges" items totaling $217,968.06 in the "Assets" column, to wit: "Unamortized balance of office alterations $5,828.59" and "Unamortized discount and expense $212,139.47." In computing net assets in connection with the "touch off" clause these items are properly eliminated.

The aggregate assets figure of $4,365,970.05 for security investments was composed of a total of $1,333,588.80 representing the market value of bonds, stocks, and a syndicate holding, and a total of $3,032,381.25 representing appraisals by the Company.[504] Included in the appraisal total of $3,032,381.25 were appraisals of the value of the Company's holdings of stock of Reybarn Company, Inc. and the United States Foil Company, Class B Common. The balance sheet stated in a footnote that the market quotations of these two stocks on December 31, 1931, "at the nominal market" were 75 cents and $2.875,[505] respectively. The Company appraised its Reybarn stock at $3.00 per share or $2.25 per share above the market quotation; its United States Foil Company stock at $9.00 per share or $6.00 per share above the market quotation.[506]

The Company apparently sought to justify its use of an appraisal value instead of a market value by the notation that the market quotations cited were "at a nominal market," i. e., that these securities had no "active market value."[507] In the month of December 1931 alone, 31,800 shares of Reybarn Company, Inc. stock were traded on the New York Curb Exchange. The price ranged between 50 cents and 87½ cents per share. In the same month 6,100 shares of United States Foil Company Class B Common were traded on the New York Curb Exchange, the price ranging between $2.87½ per share and

[504] Ibid.

[505] Ibid.

[506] It should be noted that Investors Equity Company, Inc., and Reybarn Company, Inc., which were related to Reynolds Investing Company, Inc., by a partial identity in sponsorship and directorate carried these two securities at their market quotations; see infra, p. 1828.

[507] Op. cit. supra, note 503.

$3.25 per share. Reference to the daily trading reports on the New York Curb Exchange shows that thousands of shares of stock of both Companies were traded each month of the year 1931.[508]

The appraisal gave to the Company's holding of Reybarn Company, Inc. stock an evaluation of $446,436 above the market quotation and to the Company's holding of United States Foil Company Class B stock an evaluation of $252,007 above the market quotation, constituting a total of $698,443.[509] Had these two securities been carried at market value, the net assets of the Company on December

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[508] The trading in these two stocks on the New York Curb Exchange for 1931 was as follows:

REYBARN CO., INC.

Date (1931)	High	Low	Closing sale	Volume (shares)
January	3	2¼	2⅝	13, 900
February	5	2½	[a] 3⅛	17, 000
March	3½	2⅜	2⅜	16, 000
April	2⅜	1⅝	1¾	8, 900
May	2⅛	1¾	[a] 1⅞	4, 000
June	2	1⅝	2	5, 400
July	2	1½	[a] 1½	6, 400
August	1¾	1⅜	[a] 1¼	2, 300
September	1½	¾	1	11, 700
October	1	⅝	[a] ⅞	4, 300
November	⅞	¾	¾	5, 500
December	⅞	½	¾	31, 800
Daily transactions during last week of December 1931				
Dec. 25, Friday [b]	----	----	----	----
Dec. 26, Saturday	¾	½	¾	9, 800
Dec. 27, Sunday [b]	----	----	----	----
Dec. 28, Monday	¾	⅝	⅝	1, 300
Dec. 29, Tuesday	¾	½	½	2, 200
Dec. 30, Wednesday	⅝	½	⅝	4, 400
Dec. 31, Thursday	¾	⅝	¾	3, 400

UNITED STATES FOIL CO., CLASS B

Date (1931)	High	Low	Closing sale	Volume (shares)
Janury	7	5¾	5¾	4, 600
February	9	5⅝	[a] 5¾	6, 000
March	10	7	[a] 8⅛	7, 800
April	7½	6¼	6½	2, 100
May	6¾	4½	4½	5, 700
June	6	4	5	7, 200
July	5¼	4⅜	4¾	2, 200
August	4⅞	4¼	[a] 3⅞	500
September	4	3⅛	3⅛	1, 900
October	3¾	2⅛	[a] 3½	4, 800
November	4	3¼	3¼	1, 300
December	3¼	2½	2⅞	6, 100
Daily transactions during last week of December 1931				
Dec. 25, Friday [b]	----	----	----	----
Dec. 26, Saturday	2⅝	2⅝	2⅝	900
Dec. 27, Sunday [b]	----	----	----	----
Dec. 28, Monday	2½	2½	2½	200
Dec. 29, Tuesday	----	----	----	----
Dec. 30, Wednesday	3	2⅞	2⅞	1, 600
Dec. 31, Thursday	2⅞	2⅞	2⅞	100

[a] Bid price. [b] Exchange closed.

[509] Op. cit. supra, note 503, Pt. III, Table 2. Reynolds Investing Company, Inc., held 198,416 shares of the stock of Reybarn Company, Inc., appraised at $595,248 and 41,144 shares of the Class B stock of United States Foil Company, appraised at $370,296.

31, 1931, would have been shown to be $3,890,458.17.[510] Since $3,670,-200 of debentures were outstanding at that time, the coverage on that basis on December 31, 1931, would have appeared as a trifle over 106%, or approximately 4% below the "touch-off" point.

Similarly, if the net assets of the Company as shown by the balance sheet of December 31, 1932, had been reduced by the use of market quotations of Reybarn Company, Inc. stock and the United States Foil Company Class B stock in place of the appraisal values, the net assets of the Company at that time would be disclosed as aggregating $3,770,298.71[511] and since $3,501,000 of debentures were outstanding at that time[512] the coverage would appear as 104.8% instead of the 123.30% submitted by the Company.[513]

The Company submitted that on June 30, 1932, the net asset coverage reached its lowest point—111.25%.[514] That amount of asset coverage was obtained by the use of appraisal values higher than the market quotations in the case of the two blocks of stock above mentioned. It is readily apparent that the substitution of the market quotations for the appraised values would bring the asset coverage at that time considerably below the "touch-off" point.

The propriety of appraising securities listed on the exchanges was seriously questioned by Chas. D. Barney & Co., one of the original sponsors of the Company. In May 1932 Chas. D. Barney & Co. apprised the management that it felt that "the point on which Mr. Taft's opinion is based, namely as to whether listed stocks have a market which might be termed active or not, is a very fine one."[515] It further suggested that the president of the Company might find his duties and obligations to the stockholders inconsistent with his duties to debenture holders, and requested that he apply to the Federal District Court for the appointment of an equity receiver rather than wait for this step "to be taken by a holder of the debentures or a group of such holders."[516] The Company replied that the officers were satisfied with the manner in which the net assets of the Company were determined and declined the suggestion of making application for a receivership.[517]

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[510] The net assets as computed from the balance sheet for December 31, 1931 ($4,588,901.17) reduced by $698,443.

[511] Op. cit. supra, note 503, Pt. I, Ex. E–7.

[512] Ibid.

[513] Id., Pt. IV, Table 7.

[514] Ibid.

[515] Letter of John W. Hanes of Chas. D. Barney & Co. to Reynolds Investing Company, Inc., dated May 3, 1932 (Minute Book of Reynolds Investing Company, Inc.). Mr. Hanes had been a director of Reynolds Investing Company, Inc., but had resigned as of September 24, 1931. Mr. Taft was a member of the law firm of Cadawalder, Wickersham & Taft, counsel to Reynolds Investing Company, Inc.

[516] Ibid.

[517] Reply of Reynolds Investing Company, Inc., to John W. Hanes, dated May 11, 1932 (Minute Book of Reynolds Investing Company, Inc.). The reply read in part as follows:

> I hardly need remind you that the question of whether the 110% clause of the Trust Indenture has been complied with must depend upon whether the net assets of the Company have been determined "in accordance with good accounting practice" as the indenture provides.
>
> * * * * * * *
>
> The Company has always expressed its willingness to furnish all information of its affairs to any of its security holders who are concerned over the situation or anxious for further information, and it is still willing and anxious to do so, as I personally am also. If in spite of this any of the debenture holders feel that the terms of the Trust Indenture have not been complied with, they are, of course, at liberty to take such

As late as April 1939 a sharp difference of opinion existed as to whether the Class B common stock of the United States Foil Company and the common stock of Reynolds Metals Company were properly subject to appraisal or whether they were to be taken at their market quotations.[518]

In addition to appraising two blocks of securities which the Company claimed had merely a "nominal market value," the management appraised portfolio securities which had no market at all. As noted above, the investment securities were set forth in the balance sheet for December 31, 1931, as having a combined market and appraised value of $4,365,970.05.[519] Of this total figure only $1,333,-588.80,[520] or approximately 31%, represented the market value of securities; $965,544,[521] or 22%, represented the appraisal value of the Reybarn and United States Foil Company stock which was presumed to have no active market value; and $2,066,837.25,[522] or 47%, represented securities which had no market at all. Thus, approximately 69% of the valuation of the entire portfolio consisted of appraisals made by officers and directors of the Company.

The appraisals by the management of Reynolds Investing Company, Inc. appear in several instances to have been inconsistent with appraisals of the same securities held in the portfolios of affiliated companies. This use of the higher set of values for the same securities by Reynolds Investing Company, Inc. in 1931 and 1932, elevated the total net assets of that company above the "touch-off" point. Reynolds Investing Company, Inc. was one of five investment companies which had been originally jointly sponsored by Chas. D. Barney & Co. and Reynolds & Company, brokerage firms and members of the New York Stock Exchange.[523] Upon comparison, substantial discrepancies are to be found in the values accorded to the identical securities in the respective portfolios of three of the affiliated com-

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> steps as they are advised and the matter will have to be determined on the basis of the provisions of the Trust Indenture. But any such steps will have to be taken without my cooperation and you can rest assured that in such event the Company and I personally will make every effort to prove our conviction that the terms of the Trust Indenture have been and now are being complied with to the very letter, and that the appointment of a Receiver under such circumstances would be unwarranted and in violation of the interest and rights of the security holders of the Company.

[518] Letter of Kellogg, Emery & Inness-Brown, attorneys for one of the preferred stockholders committees to the Trustees, dated April 3, 1939 (S. E. C. File No. 212–98–2B, New York Regional Office). This letter read in part as follows:

> Counsel for various Common Stockholders' interests suggest that the Class B Common Stock of United States Foil Company and the Common Stock of Reynolds Metals Company be included as "Special Interests." We share the opinion of the remaining counsel that these shares should be excluded from the definition of "Special Interests."
>
> * * * * * * *
>
> As shown above, the trading in these two stocks is sufficiently active to remove them from the class of "Special Interests." We believe that they should be classified with the other general portfolio securities.

[519] Reply to the Commission's questionnaire for Reynolds Investing Company, Inc., Pt. I, Exhibit E–6.

[520] Ibid.

[521] Ibid.

[522] Ibid.

[523] Id., Item 5.

panies, to wit: Investors Equity Company, Inc., Reybarn Company, Inc., and Reynolds Investing Company, Inc.[524]

In some instances, the same issues of securities were contained in the portfolio of Reynolds Investing Company, Inc. and in the portfolios of the other two companies; in other instances, in the portfolio of Reynolds Investing Company, Inc. and in the portfolio of one of the other companies.

The following table on p. 1832 reflects the appraisal values per share employed by Reynolds Investing Company, Inc., on June 30, 1932, as compared with the appraisals in use at that time by Reybarn Company, Inc. and Investors Equity Company, Inc.[525]

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[524] These three companies, in addition to being under the common sponsorship of the Barney-Reynolds interests, had several directorships and a number of their highest officers in common, as shown below.

Reynolds Investing Co., Inc.[a]			Investors Equity Co., Inc.[b]			Reybarn Co., Inc.[c]		
Office	From—	To—	Office	From—	To—	Office	From—	To—
JOHN W. HANES								
President	1928	1929.	Vice president.	5/1927	5/1932.	President	2/1929	12/31/35.[d]
Director	3/2/28	9/24/31.	Director	5/1927	5/1932.	Director	2/1929	12/31/35.[d]
RICHARD S. REYNOLDS								
President	3/2/28	12/31/35.[d]	Director	10/1929	8/1931.	Vice president.	9/1931	6/1932.
Director	3/2/28	12/31/35.[d]				Director	2/1929	6/1932.
CLARENCE K. REYNOLDS								
Vice president.	3/2/28	12/31/35.[d]	President	5/1927	5/1932.	President	2/1929	12/31/35.[d]
Director	3/2/28	12/31/35.[d]	Director	5/1927	5/1932.	Director	2/1929	12/31/35.[d]

[a] Reply to the Commission's questionnaire for Reynolds Investing Co., Inc., Pt. VII.
[b] Reply to the Commission's questionnaire for Investors Equity Co., Inc., Pt. VII.
[c] Reply to the Commission's questionnaire for Reybarn Co., Inc., Pt. VII.
[d] End of the period to which the Commission's questionnaire referred.

[525] This compilation and comparison of the values at which the same "special interests" were held by the respective companies is as of June 30, 1932, the date on which Reynolds Investing Company, Inc., claimed an asset coverage of 111.25%. On that date Reybarn Company, Inc., was using appraisals which had been set by the Board of Directors on June 15, 1932 (Minutes of Resolutions adopted by Board of Directors on June 15, 1932).

The last appraisals by Investors Equity Company, Inc., were set on May 17, 1932, the day prior to the transfer and sale of its assets to Tri-Continental Corporation (reply to the Commission's questionnaire for Investors Equity Company, Inc., Pt. III, Table 2). The chief reason for the transfer of the assets of Investors Equity Company, Inc., to Tri-Continental Corporation was that the latter assumed the bonded indebtedness of Investors Equity Company, Inc., which was on the point of reaching the "touch-off" level (id., Pt. I, Exhibits A1 and A3).

The valuations of "special interests" in use by Reynolds Investing Company, Inc., on June 30, 1932, were the appraisals as of December 31, 1931, approved by the directors on January 21, 1932, no new appraisals being made until December 31, 1932 (Minutes of the meeting of directors of Reynolds Investing Company, Inc., on Jan. 21, 1932; appraisals as of Dec. 31, 1931, and Dec. 31, 1932, filed by Reynolds Investing Company, Inc., as a

Title of appraised security	Investors Equity Co., Inc., as of May 17, 1932 [a] (dollars per share)	Reybarn Co., Inc., appraised values set on June 15, 1932, in use on June 30, 1932 [b] (dollars per share)	Reynolds Investing Co., Inc., appraised as of Dec. 31, 1931, in use on June 30, 1932 [c] (dollars per share)
Case, Pomeroy & Co. common	6	6	10
Case, Pomeroy & Co., pfd	80	80	100
Petroleum Reclamation Corporation, pfd	30	30	100
Royal American Corp	37.50	37.50	50
United States Foil Company "B"		[d] 2.25	[d] 9
Orange Crush Company			20
Selected Industries, Inc., conv. pfd	1.87½		7
Selected Industries, Inc., units	0.62		9.35
Stokeley Brothers Company, pfd	30		92.91
Passwall Corporation, common	1		2
Reybarn Company, Inc	[d] 0.75		[d] 3

[a] Reply to the Commission's questionnaire for Investors Equity Company, Inc., Pt. III.

[b] Minutes of directors' meeting, June 15, 1932 and reply to the Commission's questionnaire for Reybarn Company, Inc., Pt. III.

[c] Reply to the Commission's questionnaire for Reynolds Investing Company, Inc., Pt. III. The appraisal of Dec. 31, 1931, a copy of which was filed with the reply to the Commission's questionnaire, compares the appraisals as of that date with the prior appraisals for the preceding month, i. e., Oct. 31, 1931, and contains the following comments:

> Reference to Case-Pomeroy; Mr. Pike informs us that the break-down value of Case-Pomeroy is somewhere between $8.00 and $8.50. As is our usual custom we have allowed something for "good will" which item amounted to $7 a share in the original purchase.
> Case-Pomeroy Pfd., is carried at cost, as that stock is paying dividends and has liquid assets well above the total amount of the issue.
> * * * * * * *
> Passwall Corporation Preferred is carried at $27, after a check-up with the auditors and its annual statement.
> We see no change in the situation as far as Passwall Corporation common, Penn Heat control, Petroleum Reclamation preferred and Petroleum Reclamation common are concerned.
> Our large block of Reybarn Company is appraised at $3 which is approximately its break-down value, according to our figures and the statement of assets furnished to us by the company.
> Royal American Corporation is carried at $50 and we have a message from Mr. Fortington to the effect that it would be extremely difficult to arrive at an exact break-down figure of the corporation. It is less than $60 and more than $40.
> * * * * * * *
> Selected Industries Convertible Preferred has been changed from $8 to $7.
> Selected Industries Units have been changed from $11.83 to $9.35.
> * * * * * * *
> Stokely Bros. Common and Preferred, we continue to carry in a block at cost.
> * * * * * * *
> United States Foil "A" we carry at cost as before and United States Foil "B" at $9, which is approximately its break-down value.

[d] It should be noted that Investors Equity Company, Inc. carried Reybarn Company common at market and Reybarn Company, Inc. carried U. S. Foil "B" at market, while Reynolds Investing Company, Inc. gave to these securities a much higher appraised evaluation on the ground that they had only a nominal market value—see supra p. 1827.

supplement to its reply to the Commission's questionnaire). The letter, dated Feb. 24. 1937, transmitting appraisals as of Dec. 31, 1931, and Dec. 31, 1932, read as follows:

> In reference to your letter of Feb. 2nd, covering questions 6 and 7, I have gone through our files and find that the only official appraisals made by us in writing of the portfolio securities are those contained in the minute book, copies of which I am enclosing.
> As I explained at the preliminary hearing, we were in constant touch with the officials of those companies which we designate as "Special Situations," and the information received from them was largely verbal or obtained from their own records.
> Very truly yours,
> REYNOLDS INVESTING COMPANY, INC.,
> (s) W. F. WOODWARD.
> W. F. Woodward, *Secy. & Treas.*

It might be further noted that as late as May 3, 1932, the president of the Company and John W. Hanes were engaged in a discussion over the propriety of the appraisals of December 31, 1931; see supra, pp. 1829.

Investors Equity Company, Inc., had outstanding a debenture issue the indenture for which contained a 110% asset coverage "touch-off" provision and a "good accounting

The most substantial variations between the appraisals of Investors Equity Company, Inc., and/or Reybarn Company, Inc., and Reynolds Investing Company, Inc., are listed below:

	Reybarn and/or Investors Equity Co. Inc.	*Reynolds Investing Co. Inc.*
Case, Pomeroy & Co. preferred	$80.00	$100.00
Case, Pomeroy & Co. common	6.00	10.00
Passwell Corporation common	1.00	2.00
Petroleum Reclamation Corporation, preferred	30.00	100.00
Reybarn Company, Inc	.75	3.00
United States Foil Company "B"	2.25	9.00

A list of the number of shares of each of these securities held by Reynolds Investing Company, Inc. on June 30, 1932, is not available. However, the statements by the Company of "Securities Owned" show that it held precisely the same number of shares of each of the above listed securities on December 31, 1931 and on December 31, 1932.[526] Hence the inference that the same number of shares of each of the securities was held by the Company on the interim date of June 30, 1932, is fully justifiable.

The difference in the net assets of Reynolds Investing Company, Inc. (as of June 30, 1932), as the result of the use of its own appraisals instead of those of Investors Equity Company, Inc. and Reybarn Company, Inc. would amount to $936,975.[527] Reynolds Investing Company, Inc. reported net assets at market as of June 30, 1932, amounting to $3,929,608,[528] giving a coverage for the bonds of 111.25% or 1¼% above the "touch-off" point. A deduction of the aggregate $936,975 excess appraisals in the case of these six securities would show the net assets to be $2,992,633 and reduce the coverage for the $3,532,200 of outstanding debentures on June 30,

practice" clause identical with those contained in the indenture of Reynolds Investing Company, Inc. (reply to the Commission's questionnaire for Investors Equity Company, Inc., Pt. I, Exhibit K).

[526] Reply to the Commission's questionnaire for Reynolds Investing Company, Inc., Pt. III. The portfolio holdings were the same also as of December 31, 1930.

[527] See the following table:

	Number of shares held	Unit appraisal value used by Reynolds Investing Co., Inc.	Appraisal of value of holdings by Reynolds Investing Co., Inc.	Unit appraisal value used by Investors Equity and/or Reybarn Co., Inc.	Value of Reynolds Investing Co., Inc., holdings at Investors Equity—Reybarn Co., Inc., appraisals
Case, Pomeroy & Co., Inc., pfd	750	$100.00	$75,000	$80.00	$60,000
Case, Pomeroy & Co., Inc., common	17,196	10.00	171,960	6.00	103,176
Passwall Corporation, common	13,533	2.00	27,066	1.00	13,533
Petroleum Reclamation Corporation, pfd	1,650	100.00	165,000	30.00	49,500
Reybarn Co., Inc	198,416	3.00	595,248	.75	148,812
United States Foil Co. "B"	41,144	9.00	370,296	2.25	92,574
			1,404,570		467,595
			467,595		
Difference			936,975		

[528] Reply to the Commission's questionnaire for Reynolds Investing Company, Inc., Pt. IV, Table 7.

1932, to 85.15%. On that basis the net assets of the Company were not only below the "touch-off" point but less than the face amount of the bonds.

Even after the company went into reorganization proceedings, in May 1938, the ambiguities of the "touch-off" provisions presented almost insuperable difficulties.[529] It is interesting to note, in the suggested plans for reorganization, a recognition of the difficulties caused by the inadequacies of the protective provisions in the bond indenture. The plan of reorganization presented in April 1939 recommended that the following elements be clearly and unequivocably defined:[530]

a. What constitutes "net assets."

b. Which asset items are to be included or excluded in the computations.

c. How listed securities should be valued.

d. How unlisted securities, or the so-called "special situations" should be taken, and on what basis these unlisted securities should be valued.

e. Which liabilities are to be included or excluded in the balance sheet.

f. Who should prepare the balance sheet for the purpose of computation of the debtor's net assets.

It will be recalled that by Article III, Section VIII, of the Indenture the Company covenanted to redeem all the then outstanding debentures if the net assets of the Company fell below 110% of the funded debt. The vagueness of definition of net assets and the absence of adequate check-up and enforcement provisions permitted the decisions as to whether the "touch-off" point had been reached and whether any remedial action should be taken to rest in the hands of the management itself.

3. EFFECTS OF EFFORTS TO AVERT THE ENFORCEMENT OF A "TOUCH-OFF" CLAUSE

A "touch-off" provision is at least some protection to the bondholders of an investment company. However, the presence of such a clause has proved to be, in many instances, a source of injury to

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[529] "The 'touch-off' clause was the subject of heated controversy and belated compromise." (Letter of counsel for several common stockholders' committees and for First Income Trading Corporation Receiver to Trustees of Reynolds Investing Company, Inc. S. E. C. File No. 212–98–2B.)

[530] Plan of reorganization submitted to the Trustees by respective counsel for the different committees dated April 1939 (S. E. C. File No. 212–98–1A).

In November 1939 the trustees in reorganization filed with the United States District Court for the district of New Jersey a proposed plan for the reorganization of Reynolds Investing Company, Inc., which in essence provides for the complete liquidation of its assets on or before April 1, 1947. During the interim the assets of the company are to be sold gradually and applied to the repurchase of the company's outstanding bonds and preferred stocks at their face or par value, or 80% of their asset value, or at tender prices made by bondholders or preferred stockholders or market prices, whichever is lowest at the time of repurchase. On April 1, 1947, a statutory liquidation of the Company under the laws of Delaware is to occur, and the Company's assets are then to be distributed in accordance with the priority of the claims of the various classes of securities. Pending the final liquidation of the company, control of its management is to be vested in the bondholders who are given the right to elect 3 out of the 5 members of the board of the directors of the reorganized company. *In the matter of Reynolds Investing Company, Inc.*, United States District Court for the district of New Jersey, In Bankruptcy No. 27863.

the company as a whole, to the junior security holders, and possibly to the debenture holders themselves. The menace of the serious consequences that might possibly result from a violation of the "touch-off" clause caused investment companies to engage in summary liquidations of promising investments, in a declining market, thus practically wiping out the equity of the junior security investors; to sell nonincome producing securities at unpropitious times in order to purchase income producing securities; and to convert favorable investments into cash so that they might proceed to repurchase debentures at a discount and avert the "touch-off" point in that manner.

As was stated by one investment company manager, "the 'touch-off' clause operates to remove management discretion at the very time when it is most needed." [531]

While a weak "touch-off" provision and an indifferent trustee deprive the debenture holder of a vital protection, a more stringent "touch-off" provision or a more exacting trustee may precipitate action injurious to the company and the junior security holders.

a. Reliance Management Corporation and Reliance International Corporation

Reliance Management Corporation and Reliance International Corporation illustrate the effects of an attempt to avert the threat of the enforcement of a "touch-off" provision.

Reliance Management Corporation was incorporated January 25, 1929, under the laws of the State of Maryland.[532] The individuals and firms interested in the formation of this company and the distributors of its stock were Scholle Bros., Ames, Emerich & Co., Inc., F. A. Willard & Co., Estabrook & Co., and Morton H. Fry, partner of Scholle Bros.[533]

The above interests were given representation on the first board of directors, which included also one representative of the Central Hanover Bank and Trust Company and The New York Trust Company.[534] Management of the Corporation was first vested in Morton H. Fry by virtue of a management agreement dated January 26, 1929, for a period of five years.[535] Under this agreement Mr. Fry, a partner of

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[531] Public Examination, The Equity Corporation, at 1201. Erwin Rankin, of the Founders group of investment companies, testified to the harmful influence upon that group of the "touch-off" provisions in the indentures (Public Examination, American General Corporation et al., at 24896–7):

> Q. I also am informed that some of the provisions of these indentures have caused liquidation at times that was unfortunate. Isn't that so?
> A. Yes; I think that is true. I mean I can think of circumstances that you might say were compelled by the indenture that were unfortunate.
> Q. You recall such circumstances happening, do you not?
> A. I recall an instance such as in 1932, when asset values were below indenture requirement, and we felt income had to be protected when we sold non-income-producing securities, which was unfortunate.
> Q. You sold securities also in order to provide funds to buy the debentures at a discount in order to keep within the indenture protection also, didn't you?
> A. That is right. A good many things in the final analysis go back to the restrictions.

[532] Reply to the Commission's questionnaire for Reliance Management Corporation, Pt. I, Items 1 (d), (e).

[533] Id., Item 5; and Public Examination, The Equity Corporation, at 1036, 1051, and Commission's Exhibit No. 136.

[534] Reply to the Commission's questionnaire for Reliance Management Corporation, Pt. I, Exhibit D–1.

[535] Id., Exhibit C–1; and Public Examination, The Equity Corporation, at 1053–4, and Commission's Exhibit No. 140.

the New York Stock Exchange firm of Scholle Bros., was authorized to supervise the portfolio of the Corporation in cooperation with Scholle Bros., who, it was set forth in the agreement, "maintain a statistical force with a personnel trained in investigation and examination of investments, and maintain banking connections for the buying and selling of investments." [536]

On August 30, 1929, the same interests that had organized this Corporation organized Reliance International Corporation, over which Reliance Management Corporation exercised control through its holdings of the Class B common stock of the new enterprise.[537] On September 5, 1929, Reliance Management Corporation entered into an agreement to manage Reliance International Corporation for a fee equal to ½ of 1% per annum of its average aggregate resources, investments taken at cost.[538] Eventually, this contract was modified as a part of the arrangement whereby, in effect, Reliance International Corporation ceased to be a subsidiary of Reliance Management Corporation and became its parent—a switch occasioned by the company's efforts to comply with the "touch-off" provision to which the bonds were subject.[539]

On January 26, 1929, Reliance Management Corporation sold to the bankers $5,000,000 of 5% debentures at 94½ and accrued interest, and these were offered to the public by the bankers at 99½ and accrued interest.[540] The indenture under which these debentures were issued,[541] and under which the Central Union Trust Co. of New York served as Trustee, contained protective provisions frequently found in indentures. The "touch-off" provision read as follows: [542]

> The Company covenants that the current resources of the Company shall always be in excess of one hundred and twenty-five per cent (125%) of the principal amount of all its funded obligations.

"Current resources" of the Company, for purposes of estimating the requisite ratio, were to include: [543]

> The fair market value of all securities owned by the Company * * *, provided that the fair market value of the stock of controlled companies shall be deemed to be the amount which would be received by the Company as a liquidating dividend on those stocks if the controlled companies were to be dissolved and finally liquidated on the date in question;

The indenture did not contain any indication how the "fair market value" was to be ascertained. This omission, it will be noted below, enabled the management to make a temporary pretense that the "touch-off" point had not been reached.

The procedure in case of a default by the Company in the performance of this covenant as outlined in Article Eight of the indenture

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[536] Public Examination, The Equity Corporation, at 1053–4 and Commission's Exhibit No. 140.

[537] Id., at 1058, 1062, 1070, 1079.

[538] Id., at 1087 and Commission's Exhibit No. 149.

[539] Id., at 1220 and Commission's Exhibit No. 161.

[540] Id., at 1037–8.

[541] Reply to the Commission's questionnaire for Reliance Management Corporation, Pt. I, Exhibit H.

[542] Id., Exhibit H, p. 77 (Art. Six, Sec. 12, of the indenture).

[543] Id., Exhibit H, p. 20 (Art. One, Sec. 1, subsection g, 3 of the indenture).

was substantially like that provided in the case of Reynolds Investing Company, Inc.,[544] described above. There was a noteworthy difference in only one regard. While the indenture in the case of Reynolds Investing Company, Inc. required the trustee to serve a written notice of default upon the company only if requested to do so by the holders of 25% of the principal amount of debentures, under this indenture it was made the duty of the trustee to serve such a notice at the request in writing of the holder of any debenture at the time outstanding.[545]

On December 14, 1931, the Central Hanover Bank and Trust Company, successor of the Central Union Trust Co. of New York, in its capacity as Trustee, served written notice on Reliance Management Corporation to the effect that the trustee had been advised that the Corporation had failed to maintain its current resources in excess of 125% of the principal amount of all its funded obligations and that in the event such default should continue for 60 days after this notice it might in its discretion as Trustee declare the principal of all debentures outstanding due and payable immediately.[546]

In the reply which the board of directors authorized the president of the Company to make to the Trustee, it sought support in the lack of definition of the term "fair market value" in the indenture. In answer to the Trustee's notice dated December 14, 1931, charging that the Corporation had "failed to maintain its current resources in excess of 125% of the principal amount of all its funded obligations,"[547] the president stated that the Board took the position that the closing prices (or bid prices) of the securities included in the balance sheet of November 30, 1931, furnished the Trustee did not reflect their "fair market value" but that the fair market value was substantially in excess of such prices.[548] In closing, the president stated: "This Corporation therefore notifies you that it does not admit that its current resources are less than 125% of its funded obligations and therefore cannot accept your notice of default dated December 14, 1931."[549]

Notwithstanding this reply to the Trustee, the activities of the directors and officers during the period of December 14, 1931 to February 13, 1932, gave every indication that they did in reality

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[544] See supra, pp. 1823–4.

[545] Op. cit. supra, note 541, Exhibit H (p. 83), Article Eight of the indenture, entitled "Remedies of Trustee and Debenture Holders," reads in part as follows:

> SECTION 1. If one or more of the following events shall happen, that is to say:
>
> *   *   *   *   *   *   *
>
> (4) default shall be made in the due observance or performance of the covenant contained in Section 12 of Article Six and such default shall have continued for a period of 60 days after written notice thereof shall be given to the Company by the Trustee whose duty it shall be (in case of such default) to give such notice at the request in writing of the holder of any debentures at the time outstanding hereunder;
>
> *   *   *   *   *   *   *
>
> then in any and every such case the Trustee may, in its discretion, and upon the written request of the holders of not less than 25% in principal amount of the debentures then outstanding hereunder, and upon being indemnified to its satisfaction, the Trustee shall, by notice in writing, delivered to the Company, declare the principal of all debentures outstanding hereunder to be due and payable immediately, * * *.

[546] Public Examination, The Equity Corporation, Commission's Exhibit No. 152.

[547] Ibid.

[548] Id., Commission's Exhibit No. 153.

[549] Ibid. and id., at 1172–3

acknowledge the default. Morton H. Fry, president of Reliance Management Corporation at that time, testified:[550]

Q. And you did at that time refuse to admit that the closing prices reflected the fair value of the portfolio?

A. On the advice of counsel that was the attitude we took with the trust company. We felt we had some justification for that attitude inasmuch as you may recall that insurance companies and savings banks were allowed during that period to carry their securities on their published balance sheets at anything but closing prices. In other words, they had what was known as "convention values" which in some cases were closing quotations of as much as year before. So we felt we had some justification. Actually, however, I have no hesitancy in saying, because I reflect the opinion of the board, we felt a default did exist and it was up to us to take every means in our power to remedy it.

Q. Did the trustee move, as a result of its letter declaring a default, to declare the bonds due and payable immediately?

A. We were allowed, under the terms of the indenture, 60 days in which to correct the so-called default.

Q. And it was during that subsequent period that measures were taken to cure the default?

A. Measures were taken to cure the default and did cure the default. As a matter of fact, I think I should state for the purpose of the record here that there never was an actual default. A default only could have been declared effective at the end of the 60-day period, so we were never in default.

The management proceeded to consider various measures to remedy the default, the existence of which they had officially denied to the Trustee. The situation surrounding the debentures was canvassed thoroughly, offers involving sale of control were considered and discussed, a plan of raising new capital by sale of additional stock to stockholders was considered and abandoned.[551]

The policy was continued of buying the Corporation's own debentures "as cheaply as possible, inasmuch as it was necessary to sell holdings of high-grade bonds at considerable sacrifice to pay for these purchases of debentures."[552] Further, the Board "as a matter of precaution decided to convert the portfolio of this company as far as possible into cash."[553] By February 9, 1932, the entire portfolio had been sold with the exception of certain inactive securities of an approximate market value of $150,000. The procedure involved the precipitate liquidation within less than two weeks of securities which had cost $3,450,000 and at a time when prices of equity securities were at a very low ebb. The proceeds from the sales of these securities amounted only to about $1,075,000, resulting in realized losses of about $2,375,000.[554]

Speaking of this drastic liquidation, Mr. Fry stated that—

this "touch off" policy had compelled us, against our better judgment, to sell out the investment portfolio of the Reliance Management Corporation at or near what we then thought was the low point in the market, which had deprived

[550] Id., at 1175–6.
[551] Id., at 1202–5.
[552] Id., Commission's Exhibit No. 161.
[553] Id., Commission's Exhibits Nos. 157 and 161.
[554] Ibid.

the shareholders of the Reliance Management Corporation of an opportunity of a come-back, * * *.[555]

This enforced liquidation of the portfolio did not suffice to cure the default, and Mr. Fry testified that in the final analysis, the Corporation was faced with two alternatives: first, to sell its holdings of Reliance International Corporation Class B stock, which holdings could not be taken into consideration in computing the 125% coverage and thereby transform an "inadmissible" asset into an "admissible" asset; or, second, to sell additional stock to stockholders. Mr. Fry testified:[556]

* * * It was obvious, as we discussed this situation, that there were only two ways in which we could remedy it; one was through the sale of one of our assets which we were not allowed to count as coverage in the bonds, that is, a controlled corporation. I am referring to our holdings of Reliance International Class B stock. We were not allowed to use that as coverage in figuring the 125%. Therefore one of the possibilities was that we sell our holdings of Reliance International Corporation Class B stock and by so doing convert an inadmissible asset into an admissible asset, and in that way cure the default.

The other obviously was to get the stockholders who were the owners of the company to put up additional funds. Those were the only two ways in which the situation could be remedied.

Discussing the "touch off" clause as an inducing factor leading to attempts by others to acquire control of investment companies, Mr. Fry testified:[557]

As I say, that was the period when strenuous efforts were being made by various operators to acquire investment trusts. This was, I think I may be permitted to say to you, the outstanding independent investment trust in New York at that time, in that it was not under the control of any banking house or banking group. It was in very liquid form. We have no tie-ups. All our securities could have been converted into cash within twelve hours, at any time. The blocks we held were not big as compared with general market conditions. Therefore it looked like a very attractive plum for whoever could get it, in trying to build up one of these huge investment pictures.

They realize that, from the studies they had made, and they realized from those studies that with that 330,000 shares, as I recall it, of Class B stock in the Reliance Management portfolio, would give them control of the big picture; that is, the Reliance International, so we had a number of passes made at us. As a matter of fact, I began to think from the way they kept piling in on us that they were as thick as flies in August. Everybody was after us. We had offers or tentative offers from the Atlas Corporation and the Tri-Continental Corporation, American International Corporation, Mr. Wallace Groves, and I think there were a number of others that do not appear in the record, where promoters of various kinds came in to see me about the situation. These offers all took various and different forms. They were not identical. Some people wanted to handle this one way, but the nub of the whole thing was that the persons who made the offers all wanted to get voting control of Reliance International through that Class B stock. That was the essence of it.

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555 Id., at 1216.
556 Id., at 1203–5.
557 Ibid.

However, the passing of voting control of Reliance International Corporation to a new interest by a sale of the Class B stock was a prospect possessing appeal for neither the stockholders nor management of Reliance Management Corporation,[558] and, ultimately, the following steps were taken to extricate the corporation from its precarious position.

Reliance Management Corporation sold 221,000 shares of its capital stock to its controlled investment company, Reliance International Corporation, for $265,200 in cash, which proceeds enabled the former to avert the default existing in respect to the "touch off" provision. Reliance Management Corporation had only 150,000 free shares available at this time, so the officers of the corporation surrendered without consideration a block of option warrants representing the rights to purchase the additional 71,000 shares. Reliance International Corporation offered the stock at its cost to the stockholders of Reliance Management Corporation so as not to deprive them of any preemptive rights to subscribe to this new issue of stock. However, but few of the Reliance Management Corporation stockholders accepted the offer.[559]

In consideration of the purchase of this stock by Reliance International Corporation, Reliance Management Corporation, as the holder of 330,000 shares of Class B stock of Reliance International Corporation, approved certain changes in the latter's charter [560] and in the management contract existing between Reliance International Corporation and Reliance Management Corporation.[561] Amendments were made having the effect of, first, eliminating the disproportionate voting rights attending the Class B common stock of Reliance International Corporation; [562] second, giving the preferred stockholder voting rights whenever the net assets at market value fell below $60 per share; [563] and third, reducing the stated value of the preferred stock from $50 to $25 per share.[564] The principal compensation to Reliance International Corporation for contributing the funds to save the situation were the amendments to the management contract which, in effect, reduced the compensation from ½ of 1% of aggregate resources, figured on cost, to ¼ of 1% of aggregate resources figured on market value.[565]

The history of Reliance Management Corporation indicates that the "touch off" provision, if actively enforced, may prejudice the interests of the equity stockholder and sometimes the interests of the bondholders as well. It is manifest that the major difficulties of the Corporation were in large part due to the existence of a funded debt and more particularly to a "touch off" provision that the Company apparently had reason to believe would actually be enforced by the Trustee. Although the contractual rights of the debenture holders were apparently safeguarded in this instance, the measures taken for the "protection" of the debenture holder proved to be disastrous to the equity

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[558] Id., Commission's Exhibit No. 175.

[559] Id., at 1215–19, and Commission's Exhibits Nos. 157 and 161.

[560] Id., at 1217–8.

[561] Ibid.

[562] Id., at 1217, and Commission's Exhibit No. 157.

[563] Id., Commission's Exhibit No. 157.

[564] Ibid.

[565] Id., at 1216. The terms of the agreement and a summarization of the entire situation are set forth in a letter to stockholders dated February 18, 1932.

stockholder. In a period of declining markets and severe contraction of dividend income the Corporation was obliged to dispose of its investments in order to purchase its own debentures and thus reduce its funded obligations and the fixed interest charge thereon. This is an instance where an original leverage factor [566]—the ratio between the funded debt and stock capitalization—which would generally be considered fairly conservative, proved inimical to the equity stockholders who are supposed to be the beneficiaries of "leverage."

Because of the slightly more effective enforcement provisions of this indenture, or because of the alertness of the Trustee, summary liquidation of the company's assets was forced upon the management. The matter of the disposition of securities was no longer a matter of the broad investment judgment of the management, but was dictated by the exigencies presented by the presence of the "touch-off" clause. The charter granted the management broad powers, but these powers were negated and vitiated by the "touch-off" provision at a time when investment judgment was most vital. The management was constrained to transform virtually its entire portfolio into cash at a low point in the market in order to avoid the default. On the other hand, had not the Trustee acted promptly the rights of the debenture holders might have been jeopardized. Thus the difficulty of reconciling the interests of the two types of investors—holders of funded debt and holders of the equity securities—becomes apparent.

Even the steps which were ultimately taken to remedy the situation did not have a sufficiently stimulating effect in giving the equity holder a reasonable opportunity for recovery. The decline in the Company's portfolio up to that time was so severe [567] that little remained for the prospective equity investor, and capital invited to participate in the rescue of the Corporation was definitely reluctant to accept the invitation.

The effects of the enforcement of a "touch-off" provision in this instance may be said to have been fivefold. First, the equity investor was practically wiped out. Second, new capital was made almost impossible to obtain. Third, the Corporation was forced to place itself in practically a complete cash position at virtually the bottom of a continuously declining market. Fourth, even the debentures were placed in a speculative position in marked contrast to their original conservative appearance. Fifth, the continued forced liquidation in a declining market to prevent the default of the debentures drastically weakened the base upon which the equity security holder depended to retrieve his losses in a rising market.

However, in contrast, in many instances the absence of effective protective provision or the failure of prompt enforcement of protective clauses has resulted in situations where the company was permitted to drift in the hope of an upswing in security prices with disastrous results to the bondholders.

The presence of bonds in the capital structure of an investment company induces the irreconcilable conflict between the interest of the bondholder in securing the protection of a "touch-off" provision

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[566] Id., at 1046, 1050. The sum of $6,000,000 was paid for the stock and $4,950,000 for the debentures, or a total of $10,950,000, of which the investment company received $10,125,000, or $825,000 less than the total invested by the public.

[567] Id., at 1151.

and the interest of the stockholder in avoiding its menace. The fundamental character of this conflict is illustrated by the fact that two of the leading officials of Reliance Management Corporation were equally insistent on the inclusion and exclusion, respectively, of a "touch-off" provision in bonds.

Ambrose Benkert, vice president of Ames Emerich & Co., Inc. and director of the Reliance Management Corporation,[568] testified that, while he thought the "touch-off" was beneficial to bondholders and detrimental to stockholders, he "would not handle the bonds" unless a "touch-off" provision was incorporated in the indenture: [569]

Q. Do you recall how it was that the clause was included in the indenture, that the aggregate resources of the corporation should not be permitted to fall below 125% of the outstanding debentures?

* * * * * * *

Do you recall whose suggestion that was or why it was put in? Was it primarily for the security of the bondholder or primarily because that might be called a sales point in distributing?

A. Primarily for the security of the bondholders.

Q. And that point was stressed in the selling of the debentures, that they had that coverage?

A. Very emphatically stressed.

Q. Did you later have cause to have some regret about the existence of that coverage clause?

A. Only as a stockholder.

Q. Had you been a bondholder, you would have been very glad that it was there?

A. Yes.

Q. But looking at Reliance Management Corporation as an investment trust, regardless of the classes of securities, would you say that the touch-off clause for those debentures was a good thing in an investment trust of the general management type?

A. I think it is a good thing for the bondholders and a bad thing for the stockholders.

Q. And isn't it a fact, or this can be its effect, to rob the management of any discretion when perhaps that discretion and that expert advice may be most needed by the trust?

A. That is in the realm of theory.

Q. Wasn't it in the realm of practice as far as Reliance Management Corporation was concerned, later on when it became operative?

A. Whether or not it was in the realm of practice or whether it would work out advantageously, is still a matter of opinion.

* * * * * * *

Q. In retrospect, you have no doubt about the wisdom of putting it in?

A. Not at all.

Q. And if there was another trust which was to have debt, would you think that you would want a similar clause there to protect the bondholders?

A. I wouldn't handle the securities unless it had.

Q. You would not handle the bonds unless it had?

A. No.

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[568] Ames, Emerich & Co. was active in financing and organizing Reliance Management Corporation (id., at 1098).

[569] Id., at 1103–5.

Q. Particularly where the bonds were unsecured and were merely corporate promises to pay?

A. That is so.

On the other hand, Mr. Fry, the president and director of the Corporation,[570] was emphatic in stating that he would never again undertake the management of an investment company with bonds outstanding governed by an indenture containing a "touch-off" provision. [571]

Q. Well, I am particularly interested in your views on the 125% touch-off clause.

A. As to that, I would say I would never undertake under any circumstances the management of an investment company which had bonds outstanding with a touch-off clause, nor would I, as an investor, buy the common stock of a company which had bonds outstanding with a touch-off clause.

Q. You didn't think so at that time, but you certainly do today?

A. I certainly do today. My experience with the touch-off clause in the last five years has been sufficient to demonstrate that to me without any doubt whatsoever.

Q. And why do you feel so strongly about that, Mr. Fry?

A. I am speaking from the point of view of the management of the company and the investors.

Q. I understand that.

A. From the point of view of the bondholder, that is a perfectly valid safeguard from his point of view.

Q. Yes.

A. But where you have outstanding a debenture with a touch-off clause, you have nothing more than a marginal account when things go wrong. And, therefore, it is necessary, as you approach that touch-off clause, regardless of what your judgment may be, it is necessary for you to try to protect your bondholders so that they may not be in a position of selling you out completely. And it must happen—and I don't see how it can be otherwise—that very frequently when you want to be buying, and your judgment tells you that you should be buying, you have to be selling because of this so-called touch-off clause.

Q. That was your experience with Reliance Management?

A. That was certainly our experience.

Q. You think that the touch-off clause operates to remove management discretion at the very time when it is most needed?

A. There isn't any question about it.

4. THE EXPOSURE OF DEBENTURE HOLDERS TO INJURY FROM THE SAME ACTIVITIES AS HAVE BEEN DESCRIBED IN THE CASE OF PREFERRED STOCK

Generally, the debenture holder is subject to the same abuses as those which impair the position of the preferred stockholder.

a. Payment of Dividends Out of "Capital" [572]

A distribution of dividends to common stock or to a junior preferred stock which impairs the "cushion" of a senior preferred stock

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[570] Id., at 1201.

[571] Id., at 1148–50.

[572] See supra, pp. 1709–30.

obviously reduces the coverage for the bond issues. Moreover, a payment of dividends to a senior preferred stock, when the bonded indebtedness is not amply covered, constitutes an injury to the bondholder.

The preservation of adequate junior capital is an indispensable condition for any sound bond investment. As has been noted above, in connection with preferred stock, corporation laws generally permit the reduction of capital to a nominal sum and the distribution to stockholders as dividends of the surplus obtained by the reduction. This may result in the withdrawal of a substantial part of the capital and surplus upon which the bondholders rely as a cushion.

Frequently the reduction of stated capital has been resorted to in order to eliminate large profit-and-loss balance-sheet deficits and permit the continuation or resumption of dividends on capital stock before the past losses have been made up.[573]

An effort to protect bondholders from distribution of a surplus obtained in this manner is represented by a "touch off" clause in the indenture which requires the retention by the company of a certain margin of resources above the indebtedness, or by a provision in the indenture specifically prohibiting dividends or other distributions to stockholders unless such an adequate margin will exist after the distribution. The deficiencies of such clauses by reason of ambiguity or unenforceability have been noted above.[574]

b. Repurchases of Bonds [575]

As has been pointed out, repurchases by an investment company of its own preferred stock at a price less than the current liquidating value of that stock effect a shifting of assets between security holders—the retiring preferred stockholder receives less than he would have received upon immediate liquidation of the company, and what he has relinquished accrues to the common stockholder and to the remaining senior security holders.[576]

The repurchase of bonds at prices less than those the bondholder would obtain upon immediate liquidation of the company effects a similar redistribution of the assets of the company—what the retiring bondholder has sacrificed in asset values accrues to the junior securities or to the remaining bondholders. If the repurchase at a discount from asset value [577] is made at a time when the bonds are "under water",

[573] See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pt. VII, Sec. III; see also Graham and Dodd, *Security Analysis* (1934), pp. 224–7.

[574] See supra, pp. 1807–42.

[575] See supra, pp. 1749–74.

[576] See supra, pp. 1758–61. If the preferred stock is fully covered all the profit accrues to the common stock; if the preferred stock is "under water," some or all of that profit must be applied first to making up the preferred stock deficit.

[577] By the "asset value" of a bond is meant the amount the holder would receive upon immediate liquidation of the company; i. e., the liquidation figure specified in the indenture if the company's assets are adequate or the precise amount distributable to the bondholder in the case where the bonds are "under water."

The term "asset coverage" is identical with "asset value" only in the case where the bonds are not fully covered, since under such circumstances the bondholder on liquidation would receive distribution to the precise extent of the asset coverage. When the bonds are fully covered "asset coverage" refers to the extent of the cushion for the bonds above the specified liquidating value.

the "profit" will increase the asset value of the remaining bonds; if at a time when the bonds are fully covered, the "profit" will make up the deficit in the preferred stock, if such exists, or increase the asset value of the common stock.

The strains upon management due to the presence of bonds or debentures in the capital structure is greater than the pressure due to preferred shares. Ordinarily, even if the assets of a company are inadequate to fully liquidate the preferred stock at its par or specified value (the preferred stock being "under water") or the dividends are not paid, the company has committed no breach of agreement in respect to the preferred stockholders entitling the preferred stock to demand a liquidation of the company. But the failure on the part of the company to maintain a specified minimum cushion of assets above the face amount of the bonds or the failure to pay the required interest generally constitutes a breach of a vital covenant of the bond indenture and may result in the enforced liquidation of the company.

The main object of the so-called "touch-off" provision is to enable the bondholder, when the company has infringed upon the specified margin of safety, to obtain the principal amount of his bond (or all the net assets if these assets are not sufficient to pay the full amount) by a liquidation of the company. If, when the "touch-off" point is reached, the company, instead of taking steps to liquidate outstanding bonds at their principal amount or at least at full current asset value, proceeds to repurchase the bonds at below asset value, the company is rendering nugatory the assurances to the bondholders in the "touch-off" provision. The bondholder desirous of disposing of his holding would naturally not be inclined to accept the market price or discount prices tendered him by the company, if the company and the trustee were helping him to secure the higher liquidation value which he would get through the enforcement of the "touch-off" provision.

Many investment companies from 1931 through 1935 reacquired large blocks of their bonds, either just before or after the "touch-off" point had been reached, at prices far below what the holders would have received had there occurred a formal liquidation provided for in the indenture. The repurchase programs conducted by International Securities Corporation of America, Second International Securities Corporation, and United States & British International Company, Ltd., members of the United Founders Corporation group of investment companies, and the reacquisition activities of Eastern Utilities Investing Corporation are illustrative of this practice.

(1) INTERNATIONAL SECURITIES CORPORATION OF AMERICA, SECOND INTERNATIONAL SECURITIES CORPORATION AND UNITED STATES & BRITISH INTERNATIONAL COMPANY, LTD.

International Securities Corporation of America, Second International Securities Corporation and United States & British International Company, Ltd., three of the investment companies in the United Founders Corporation group, had aggregate assets of $115,000,000 at the close of 1929. Each company had outstanding debentures, preferred stock and common stock issues.[578] Each of the indentures under

[578] Public Examination, American General Corporation et al., Commission's Exhibits Nos. 3402, 3407, 3409.

which the debentures were issued had "touch-off" clauses requiring the maintenance of an asset coverage of 125% of the principal amount of the debentures outstanding, and providing that, in the event this coverage was not maintained, the trustee might in its discretion serve notice of default on the debtor company and demand payment of the face amount of the debentures and, upon demand of a prescribed percentage of the debenture holders, was obligated to do so.[579]

In 1931 the assets of both International Securities Corporation and United States & British International Company, Ltd. fell below the 125% coverage requirement for debentures outstanding and in the following year there was a similar deficiency in the asset coverage for Second International Securities Corporation. When the approach of the "touch-off" point threatened, these three investment companies entered upon a program of purchasing their outstanding debentures. The amounts paid to the debenture holders were not only less than the principal amount of the debentures but less than the current "asset value" of the debentures; that is, less than the amount which the debenture holders would have received upon a liquidation of the company at the time of the repurchases. The intended objective of the repurchase programs was to regain the prescribed asset coverage of 125% for the bondholders who did not retire by applying to the remaining outstanding bonds profits made by the company at the expense of the bondholders who surrendered their bonds below asset value.[580]

From May 31 to November 30, 1931, International Securities Corporation of America repurchased $2,918,000 face amount of its bonds at a total price of $1,779,992. The asset coverage for the bonds was 142% on May 31, 1931, the beginning of the 6-month period, and 105% on November 30, 1931, the end of the period. The point of "touch-off" had therefore been substantially passed. However, throughout this period the company was possessed of sufficient assets to pay the full principal amount to the holder of every bond. Nevertheless, the holder whose bond was repurchased in this period received an average price of only $61 per $100 face amount of the bond. Yet the holder who, unable to secure liquidation of his holding at its asset value, sold his bond at an average price of $61 in this six-month period, received more than the bondholder whose security was repurchased by the company in the next six months. Between November 30, 1931 and May 31, 1932, the company repurchased $12,571,000 face amount of bonds at an average price of $53.[581] As has been indicated, at the beginning of the period the "asset coverage" of the bonds was 105%. At the end of the period, when the assets of the company were at their lowest recorded point, the company still had sufficient assets to liquidate $100 face amount of bonds at $77. Thus the holders who were retired during this period received between $47 and $24 per $100 face amount less than the "asset value" of their bonds.

Although during the succeeding year (May 31, 1932 to May 31, 1933) the asset coverage of the remaining bonds rose to and beyond

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[579] Id., Commission's Exhibits Nos. 3401–D, 3406–D, and 3408–D.

[580] Id., at 25327–8.

[581] Id., Commission's Exhibit No. 3401 (F6–8); see also Table 33. For discussion of failure of trustee to act, see infra, pp. 1848–9.

the face value, due in part to the influence of the prior repurchases of the company at an asset profit to it, the holders whose bonds were repurchased by the company in that year received an even lower average price—$41 in the first half of the year and $42 in the latter half. Throughout the period from May 31, 1930 to May 31, 1933, the company repurchased in the aggregate $17,399,000 face amount of debentures at an average discount from asset value of approximately $39 and at a discount from face amount of $43.[582]

Table 33 shows that bondholders, instead of receiving the face amount of their bonds, once the "touch-off" point had been reached, as was the implied assurance of the "touch-off" provision,[583] received less than the face amount when the bonds were fully covered and substantially less than the asset value when the bonds were "under water."

The debenture issues had been entirely distributed by Harris, Forbes & Company, an investment banking firm, with the exception of slightly over $900,000 face amount, which was a residue of a much larger issue which had been distributed by International Securities Trust prior to its incorporation.[584]

TABLE 33.—*Repurchases and retirement of 5% debentures of International Securities Corporation of America, May 31, 1930 to May 31, 1933*

6 months ending—	Face amount of debentures repurchased	Total amount paid	Average price paid per $100 face amount	Arithmetic mean of asset coverage at beginning and at end of period (percent)	Approximate discount from asset value [a]
Nov. 30, 1930	$483,000	$381,084	$79	171	$101,916
May 31, 1931	1,195,000	885,184	74	150	309,816
Nov. 30, 1931	2,918,000	1,779,992	61	124	1,138,008
May 31, 1932	12,571,000	6,703,732	53	91	4,735,878
Nov. 30, 1932	113,000	46,096	41	87	52,300
May 31, 1933	119,000	49,787	42	104	69,213
May 31, 1930 to May 31, 1933	17,399,000	9,845,875	57		6,407,131

[a] When the debentures were fully covered the discount is the difference between the total amount paid during the period and the face value of the debentures repurchased. When the debentures were "under water" during the period, the discount is the difference between total amount paid during the period and the aggregate asset value of that amount of bonds based on the arithmetic mean of the asset coverage at the beginning and at the end of the period.

The Company, when it decided to take steps "in order to secure the ratio of assets [125%] to the face value of the debentures," proceeded to make offers either directly or through Harris, Forbes & Company "by which the debenture holders could surrender their debentures to the Company to be purchased at a fixed price." As has been noted, the prices offered and at which the debentures were repurchased were uniformly far below their asset value. The debentures were not, apparently, readily forthcoming in response to offers at these low

[582] Op. cit. supra, note 578, Commission's Exhibit No. 3401 (F–4 to 10). See Table 33.

[583] Section 39 ("touch-off" provision) and Section 17 (redemption—at the election of the company) of the Indenture (id., Commission's Exhibit No. 3401 (Exhibit D)).

[584] Op. cit. supra, note 578, Commission's Exhibits Nos. 3402 (p. 6), No. 3407 (p. 122), and No. 3409 (p. 96).

prices. As was stated, "it took considerable work to go out and get them in, work and time and expense" and the Company paid Harris Forbes & Company a commission of close to 6% for gathering in these bonds.[585]

Mr. Granbery, who represented Harris Forbes & Company on the board of directors of the investment company, testified: [586]

Q. Isn't that rather a high commission, Mr. Granbery, to obtain these securities? * * *

A. * * * I believe you will find those International Securities bonds were sold in very small amounts all over the country, and it took considerable work to go out and get them in, work, and time and expense.

Q. Do you recall whether the Commission you got for buying in these bonds was larger than the underwriting commission you got for putting them out?

A. The percentage was; yes, sir.

At the time when the impingement upon the "touch-off" point was becoming imminent, the Company could have increased the asset coverage of the outstanding debentures and yet preserved the asset value to the bondholders who were to be retired, by invoking the method of reacquisition of debentures described in the Indenture.[587] The Indenture provided that the Company had the absolute right to redeem or buy up all or any part of a particular series by publishing a notice to the effect that it had elected to so redeem at the prices specified in the debentures themselves.[588] The redemption prices specified ranged from 103% of the principal sum (up to June 1, 1930) to 100% (after June 1, 1945), the premium declining progressively between the two dates.[589] However, this procedure was not invoked but the debentures were reacquired by purchase at discounts. The result of this repurchase program was, therefore, that the bondholders who held on to their bonds until 1936 "received 100 cents on the dollar for their bonds and 5% interest while they were outstanding,"[590] while the bondholder who was prevailed upon by the distributing banker and the management of the company to surrender his bond, relinquished to the other security holders a substantial part of the asset value of his bond.[591]

Harris, Forbes & Company, which had sold the debentures of the Company, had placed a representative, E. C. Granbery, on the board of directors to look after the interests of the debenture holders. In addition to this role, Mr. Granbery represented the interests of

[585] Id., at 25327–8 and 25335–6.

[586] Id., at 25336. Mr. Granbery expressed the opinion that, in the matter of disposing of his securities, the average investor relies largely on the advice of the banker who sold him the securities (id., at 25339):

> I think you will find that the average private investor does not make a deep study of the securities, but relies to a considerable extent on the recommendation of the house with whom he does business.

[587] While the asset coverage is higher than the redemption price, reacquisition at the redemption figure will increase the asset coverage of the nonretired debentures.

[588] Op. cit. supra, note 578, Commission's Exhibit No. 3401 (Exhibit D, Secs. 17 and 24).

[589] Ibid.

[590] Id., at 25328.

[591] A considerable proportion of the preferred stock and the common stock of the Company was at this time in the hands of American Founders Corporation, the parent company, and thus the shift of assets effected by the repurchase program redounded, in a substantial degree, to the favor of the management interests (id., Commission's Exhibit No. X3405 [p. 111]).

Harris, Forbes & Company and was a stockholder and a director of United Founders Corporation and American Founders Corporation,[592] which owned the major part of the junior securities of International Securities Corporation of America.[593] The enforcement of the "touch-off" provision, i. e., compulsory liquidation of the debentures, would have resulted in the sacrifice or destruction of these equity interests.[594] When the assets of the Company fell below the 125% level, Mr. Granbery decided that "it was better business for everybody concerned not to force that default clause and let the Company ride through." The alternative adopted by the Company, in which Mr. Granbery acquiesced, was the program of gathering in the debentures at an asset loss to the retiring debenture holders and a resulting asset gain to the junior securities. Mr. Granbery conceded that it was to the interest of the junior security holders not to have the debentures foreclosed.[595]

Q. Now, the interest of the equity holders, I suppose, was not to have the debentures foreclosed?

A. Right.

* * * * * * *

Q. And you think you could protect the American Founders, whose interests were entirely conflicting with the debenture holders?

A. Yes, sir.

* * * * * * *

Q. As a stockholder of United Founders, you were interested, naturally, in seeing that those companies did not foreclose or enforce the debentures?

A. That thought did not enter my head at all.

Q. I am quite prepared to believe it did not, but I am thinking about the position of a person with less mental fortitude, shall we say, being in that situation where he had to represent himself, American Founders, and the equity holders, and also look after the interest of the bondholders. Do you think that could be done without any difficulty?

A. I am perfectly willing to agree with you that the value of my United Founders stock would be affected if the subsidiary trusts were wiped out of existence. From that standpoint, I was financially interested.

The program of gathering in debentures, at prices far below the asset value of the debentures was followed in the case of two other companies of the Founders group: Second International Securities Corporation and United States & British International Company, Ltd. Tables 34 and 35 disclose the discrepancies between the average prices paid to the holders of the debentures and the mean asset coverages during the time of the repurchases.

From May 1930 through May 1933, all three investment companies repurchased an aggregate of $24,138,000 face amount of their debentures at a discount from face amount of 43% and at a discount from current asset value of approximately 41% (Tables 33, 34, and 35).

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[592] Id., at 25323–4. Harris, Forbes & Company was also represented on the board of directors of International Securities Corporation of America by Don C. Wheaton.

[593] Id., Commission's Exhibit No. X3405 (p. 111).

[594] Id., at 25334.

[595] Id., at 25324–5 and 25333–4.

TABLE 34.—*Repurchases and retirement of 5% debentures of United States & British International Co., Ltd., May 31, 1930 to May 31, 1933*

6 months ending—	Face amount of debentures purchased	Total amount paid	Average price paid per $100 face amount	Arithmetic mean of asset coverage at beginning and at end of period (percent)	Approximate discount from asset value [a]
Nov. 30, 1930	$149,000	$117,755	$79	231	$31,245
May 31, 1931	159,500	118,080	74	182	41,420
Nov. 30, 1931	425,500	297,195	70	139	128,305
May 31, 1932	2,615,500	1,406,092	54	102	1,209,408
Nov. 30, 1932	94,000	40,920	44	96	49,320
May 31, 1933	70,500	31,062	44	106	39,438
May 31, 1930 to May 31, 1933	3,514,000	2,011,104	57		1,499,136

[a] When the debentures were fully covered the discount is the difference between the total amount paid during the period and the face value of the debentures repurchased. When the debentures were "under water" during the period, the discount is the difference between total amount paid during the period and the aggregate asset value of that amount of bonds based on the arithmetic mean of the asset coverage at the beginning and at the end of the period.

TABLE 35.—*Repurchases and retirement of 5% debentures of Second International Securities Corporation, May 31, 1930 to Nov. 30, 1932*

6 months ending—	Face amount of debentures purchased	Total amount paid	Average price paid per $100 face amount	Arithmetic mean of asset coverage at beginning and at end of period (percent)	Approximate discount from asset value [a]
Nov. 30, 1930	$100,000	$80,140	$80	277	$19,860
May 31, 1931	196,000	147,608	75	225	48,392
Nov. 30, 1931	199,000	127,070	64	177	71,930
May 31, 1932	2,569,000	1,358,755	53	125	1,210,245
Nov. 30, 1932	161,000	76,171	47	118	84,829
May 31, 1930 to Nov. 30, 1932	3,225,000	1,789,744	55		1,435,256

[a] Since the debentures were fully covered throughout the period, these figures represent the difference between the total amount paid during the period and the face value of the debentures repurchased.

(2) EASTERN UTILITIES INVESTING CORPORATION [596]

In March 1939 Eastern Utilities Investing Corporation, which had been a public utility holding company from 1924 to 1927, at which latter date it had been allegedly turned into an investment company, issued $35,000,000 5% gold debentures. From 1925 to 1936, when Eastern Utilities Investing Corporation was placed in reorganization under Section 77B of the Bankruptcy Act, the corporation was completely dominated by the Associated Gas & Electric System, which was under the control of H. C. Hopson and J. I. Mange.

Beginning with September 1925 when Associated Gas and Electric Corporation first purchased control of Eastern Utilities Investing

[596] For a detailed discussion of the history of Eastern Utilities Investing Corporation and a brief outline of the Associated Gas & Electric System, see Ch. II of this part of the report, pp. 624–776, and Appendixes G and H, p. 790 et seq.

Corporation, the latter served as an instrumentality for supplying financial resources to the Associated Gas and Electric Company system and as a receptacle for the securities of Associated Gas and Electric Company and its affiliated companies. By means of the debenture issue, Eastern Utilities Investing Corporation secured $35,000,000 from the public, not for the purpose of investment in the diversified securities of public utilities and allied enterprises, as proclaimed, but to be turned over intact to Associated Gas and Electric Company in exchange for blocks of securities of companies in the system. In fact, the $32,812,500 of cash proceeds received from the sale of the debentures was immediately turned over by Eastern Utilities Investing Corporation to Associated Gas and Electric Company in exchange for securities of Associated Gas and Electric Company and securities of its subsidiaries.[597]

A substantial part of the funds secured by Associated Gas and Electric Company through the Eastern Utilities Investing Corporation bond issue was used by Associated Gas and Electric Company in acquiring stock of General Gas & Electric Corporation. Mr. Stix, comptroller of Association Gas and Electric Company and familiar with these transactions, conceded it would not have been desirable for Associated Gas and Electric Company to issue its own debentures, which would have had to carry at least 5% interest, to buy the stock of General Gas and Electric Corporation which was paying only about 2% cash dividends. Hence, Associated Gas and Electric Company had Eastern Utilities Investing Corporation issue debentures and used the money contributed by the public for the purchase of the General Gas & Electric Corporation stock. Mr. Stix conceded that Associated Gas and Electric Company had Eastern Utilities Investing Corporation raise money from the public with the intent of using that money in a manner which would not have been justifiable with the proceeds of a debenture issue of its own.[598]

Part of the cash proceeds of the debentures sold by Eastern Utilities Investing Corporation was used by Associated Gas and Electric

[597] Public Examination, Eastern Utilities Investing Corporation, Commission's Exhibit No. 3772, Item 4. Mr. Stix was unable to state specifically who made up the list of securities transferred to Eastern Utilities Investing Corporation: "Actually, I don't think we paid much attention to it; at least we did not give it any serious import because one of the purposes of the financing was to help raise money for Associated Gas and Electric Company" (id., at 25019).

[598] 21A Proceedings *In the matter of Eastern Utilities Investing Corporation*. United States District Court for the District of Delaware, pp. 1115–7.

A. I would say that the net cost of the money to Associated was probably somewhere between 4¾ and 5%.

Q. And had you raised that money through debenture issue, it would have made your acquisition of General Gas unprofitable?

A. I think that is right, and perhaps impossible.

Q. That is impossible, I take it, because you think it would have been bad business judgment to have invested the money which cost 5% in a situation which at the most would have paid a return of 4% or 4½% or something?

A. That is correct.

Q. And those circumstances necessarily led you to explore every possibility of acquiring capital interest?

A. No; we had explored them already, and we were in the way of raising this money through Class A stock.

Q. Was there not one source which you had not tapped, to wit, Eastern Utilities Investing Corporation?

A. Yes.

* * * * * * *

Q. And did you sometime in the early part of 1929 decide upon utilizing the Eastern Utilities Investing Corporation as a means of obtaining additional funds from the public through the sale of Eastern Utilities Investing Corporation debentures?

A. We did.

Securities Company to conduct market operations in the Class A stock of Associated Gas and Electric Company.[599] Subsequently Associated Gas and Electric Securities Company, Inc., sold a substantial block of this stock to Eastern Utilities Investing Corporation at the inflated prices.[600]

The effect of the control of Eastern Utilities Investing Corporation by the Associated Gas & Electric System is shown by the fact that whereas in 1929 the equity assets in Associated Gas and Electric Company were only 1¾ times its funded debt as compared with the equity in Eastern Utilities Investing Corporation of 2⅛ times its funded debt, at the end of 1936 Eastern Utilities Investing Corporation was in reorganization proceedings under Section 77B of the Bankruptcy Act (at the direction of Associated Gas and Electric Company), while Associated Gas and Electric Company was still a going concern.[601]

The degree to which the interests of Eastern Utilities Investing Corporation, and that of the bond-holding public which had entrusted $35,000,000 to be used for diversified investment by Eastern Utilities Investing Corporation, were subordinated to the plans of the controlling personalities of the Associated system may be gauged by the fact that from 1925 to October 1936 Eastern Utilities Investing Corporation did not enter into a single substantial transaction involving purchase, sale, or exchange of securities except with some Associated Gas & Electric System company.[602] Mr. Stix frankly asserted that "the Associated companies got all the benefit from Eastern Utilities Investing Corporation's financing." [603]

Before the end of 1931 the condition of the bonds had already become very precarious. In a letter to the holders of prior preferred stock, dated November 12, 1931, the Company referred to the possibility of default under the 125% asset coverage provision (the "touch-off" clause for the bonds). From the date of the original sale of the issue to the public, considerable amounts of the bonds had kept coming back on the market which the underwriting syndicate kept buying and reselling through its sales organization. H. C. Hopson, the dominating influence in the Associated Gas & Electric System, apparently backed up the underwriters in maintaining the market in the debentures until about May 1931 when he grew "tired of trying to keep the market in line by purchasing bonds," and conceived the idea of promoting exchanges which would "take off the market substantial amount of bonds." [604]

The new program of "taking the bonds off the market" by exchanges was actually a form of reacquisition in order to avoid the possible taking effect of the touch-off contained in the bond debenture. By

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[599] Op. cit. supra, note 597, at 24710, 24727, and Commission's Exhibit No. 3771 (Pt. VII, Table 32).

On April 3, 1929, 77,500 shares of Associated Gas and Electric Company Class A stock which had been bought by Associated Gas and Electric Securities Company, Inc., from its parent, the issuer, at a price of $35.00 per share was sold to Eastern Utilities Investing Corporation at $57.00 per share (id., Commission's Exhibit No. 3811). Later in the same month Eastern Utilities Investing Corporation bought an additional 121,500 shares.

[600] Ibid.

[601] Id., at 25120–1, and Commission's Exhibit No. 3783.

[602] Id., at 23563, 25779–80 (Mr. Stix), and 24326–9 (Mr. Bowman).

[603] Id., at 24779.

[604] Id., Commission's Exhibit No. 3843, Items 26 and 27.

this clause the Company covenanted that it would at all times maintain a ratio of assets to funded debt of at least 125% and that if at any time the ratio should fall below 125%, the Trustee (The New York Trust Company) in its discretion or upon the demand of the holders of 15% of the face amount of debentures could declare the debentures in default.[605]

Operation of such "touch-off" clauses was in many instances sought to be avoided by the direct repurchase and retirement of some of the bonds.[606] In taking bonds of Eastern Utilities Investing Corporation out of the hands of the public by the exchange program, the management which dominated both the Associated Gas & Electric System and Eastern Utilities Investing Corporation contemplated securing an increase of coverage for the remaining debentures similar to that effected by direct repurchases. At the same time, the Associated Gas & Electric System secured other advantages. First, instead of paying cash to the holders of the Eastern Utilities Investing Corporation bonds, Associated Gas and Electric Company and General Finance Corporation, an affiliate of Associated Gas and Electric Company, gave them securities of the System. Second, instead of reacquiring the bonds directly from the public, Eastern Utilities Investing Corporation reacquired the bonds from its affiliates, paying for them with portfolio securities on a basis higher than the outside holders of bonds could obtain. Third, instead of retiring the bonds so reacquired, Eastern Utilities Investing Corporation had them transferred to a dummy corporation, thereby putting itself in a position to contend that these bonds should be regarded as eliminated in calculating asset coverage but should be considered outstanding in calculating the amount of the debentures required to compel the trustee to act.

In June 1931 Associated Gas and Electric Company and several of its subsidiaries, particularly Associated Gas and Electric Securities Company, Inc., and General Finance Corporation, made the first of a series of offers to the holders of the debentures of Eastern Utilities Investing Corporation to transfer to them securities of other members of the Associated Gas & Electric System in exchange for their Eastern Utilities Investing Corporation bonds.[607]

The bond reacquisition program may be divided into two periods on the basis of a difference in primary objectives. Through 1931 and the first part of 1932 the main objective was "to decrease the amount of outstanding debentures in a greater ratio than the decrease in assets," and the maintenance of the minimum asset coverage required by the "touch-off" provision. However, in June 1932 the Trustee notified the Company of its default in the matter of asset coverage for the bonds. Thereafter the objective of the reacquisition program was the mustering of enough debentures to vote amendments to the trust indenture eliminating the "touch-off" provision.

[605] That the Trustee was not equipped with real power to secure compliance with the "touch-off" provision nor to enforce remedies available upon a default and that the Trustee did not utilize any discretionary power which he might have had, in favor of the debenture holders, is discussed at greater length in Ch. II of this part of the report, pp. 624–776.

[606] The repurchase and retirement of a bond at a cost to the company of less than the existing coverage would have the effect of increasing the coverage of the remaining bonds.

[607] A simultaneous campaign was carried on for the reacquisition of the preferred stock of Eastern Utilities Investing Corporation. A discussion of these activities will be found in Ch. II of this part of the report, pp. 624–776.

The intensity of the program to reacquire the debentures of Eastern Utilities Investing Corporation is indicated by the fact that during the last half of 1931 Associated Gas and Electric Securities Company, Inc. sent six different offering letters. No disclosure was made that either Associated Gas and Electric Securities Company, Inc. or General Finance Corporation was a subsidiary of Associated Gas and Electric Company, nor that both of these companies were part of the same system with Eastern Utilities Investing Corporation.[608] The bankers, Harris, Forbes & Company and Halsey, Stuart & Co., Inc., who had marketed the debenture issue, urged the acceptance of the 1931 exchange offers.[609]

Eastern Utilities Investing Corporation itself urged the acceptance of the offers.[610] In fact, Eastern Utilities Investing Corporation persisted in holding itself out as a diversified investment company by attributing the decline in the market price of its bonds "to the fact that investment companies' securities, such as those of Eastern Utilities Investing Corporation, are not in favor with the investing public, who seemingly fear for the safety of income and principal in the face of the continued decline in security prices."[611] Eastern Utilities Investing Corporation urged the acceptance, in exchange, of the securities of Associated Gas and Electric Company on the theory that they were materially different from the securities of Eastern Utilities Investing Corporation, when as a matter of fact the portfolio of Eastern Utilities Investing Corporation itself consisted at the time principally of securities of Associated Gas and Electric Company.

The Trustee (The New York Trust Company) declined to advise individuals on the merits of the exchanges or vouchsafe information on the asset value of the portfolio, and referred inquirers to Eastern Utilities Investing Corporation itself.[612] To the holders of the debentures neither the corporation nor the Trustee intimated the imminent infringement upon the "touch-off" clause although that possibility was disclosed to the holders of the preferred stock for the purpose of persuading the latter to accept exchanges.[613] Many debenture holders sought the advice of brokers, security dealers, and investment houses, and the advice from these sources may not have been entirely unbiased as the Associated Gas & Electric System paid commissions to bankers who recommended the acceptance of these exchange offers.[614]

The debenture holder was faced with the difficult problem, which frequently confronts the holders of the securities of multiple-security companies, of ascertaining not only the merit of the particular security which he held but the comparative merit of the other securities which he was offered in exchange.[615]

By December 1931 the Associated Gas & Electric System had accumulated in Associated Utilities Corporation, a subsidiary of Associated Gas and Electric Company, $18,398,000 principal amount of

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[608] Op. cit. supra, note 597, Commission's Exhibit No. 3772.

[609] Ibid.

[610] Id., Commission's Exhibit No. 3772, Item 39.

[611] Id., Commission's Exhibit No. 3772, Item 39 (p. 5).

[612] Id., at 23787–8.

[613] Id., Commission's Exhibit No. 3772, Item 40.

[614] Id., at 26002–3.

[615] See discussion supra, pp. 1674–1707.

Eastern Utilities Investing Corporation debentures. The System had transferred to the former holders of the debentures $672,329 in cash and the following amounts of Associated Gas and Electric Company securities:

$16,705,000 principal amount of Associated Gas and Electric Company 4½% Convertible Gold Debentures, due 1949;

$221,000 principal amount of Associated Gas and Electric Company 4½% Gold Debentures, Bond, Consolidated Refunding Series, due 1958;

$489,000 principal amount of Associated Gas and Electric Company 5% Convertible Certificates.[616]

In December 1932 Eastern Utilities Investing Corporation proceeded to effect a transfer to itself of the $18,000,000 of debentures held by Associated Gas and Electric Company in exchange for securities contained in the portfolio of Eastern Utilities Investing Corporation. This transaction was consummated in the form of a general exchange offer, thus purporting to give the outside holder of Eastern Utilities Investing Corporation bonds the same opportunity as Associated Gas and Electric Company. Actually, all the debenture holdings of Associated Utilities Investing Corporation, the subsidiary of Associated Gas and Electric Company, were acquired by Eastern Utilities Investing Corporation at par, while only an insignificant amount of the publicly held debentures was reacquired, and that at a discount.[617]

The form of this exchange offer was unusual. Instead of offering the holders of its debentures a specific amount of portfolio securities in consideration for the surrender of the debentures, Eastern Utilities Investing Corporation asked the debenture holders to make tenders. Eastern Utilities Investing Corporation accepted the tender by Associated Gas and Electric Company of all of the $18,354,000 principal amount of debentures held by the latter; very few of the publicly held debentures were tendered and these were accepted on a lower exchange basis.[618]

The $18,354,000 face amount of debentures were not directly reacquired by Eastern Utilities Investing Corporation but were transferred to a hitherto totally inactive subsidiary of Eastern Utilities Investing Corporation.[619] By this time a question as to whether Eastern Utilities Investing Corporation was in a status of compliance with the "touch-off" provision had been raised from a number of sources. The management feared that the holders of 15% of the face amount of the indentures might be assembled to coerce the

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[616] Op. cit. supra, note 597, Commission's Exhibit No. 3772, Item 19; Commission's Exhibit No. 3775; and the Annual Report of Associated Gas and Electric Company, p. 35.

[617] Op. cit. supra, note 597, Commission's Exhibit No. 3882.

[618] Halsey, Stuart & Co., Inc., one of the two banking firms that had distributed the debentures originally, advised its clients to ignore the exchange offer (id., at 25989–90). An inter-office communication of Halsey, Stuart & Co., Inc., read in part as follows:

> Think our only course is to insert bulletin notice that we favor ignoring the exchange offer due to the fact that the company will not disclose its portfolio and that the biggest holder, the Associated Company, refuses to state at what price it is going to turn its debentures in and what it will take in exchange * * *. We are only concerned with the fact that Hopson is not presenting the matter fairly to the Eastern Utilities Investing Corporation debenture holders. Stuart (id., Commission's Exhibit No. 3843, Item 39).

[619] Tax Proceedings *In the matter of Eastern Utilities Investing Corporation,* United States District Court of Delaware, No. 1247, p. 237.

Trustee into action. If the $18,000,000 in debentures were retired a smaller number would be sufficient to constitute the required percentage. On April 12, 1932, the Utility Accountants and Tax Consultants certified that as of December 31, 1931, there were only $16,506,000 principal amount of debentures outstanding and that the amount of the coverage of the debentures, using this basis, was 150%. The asset coverage arrived at by this method of computation showed a compliance with the "touch-off" provisions (125%) and with the prerequisite (150%) for the payment of dividends. However, on the records of The New York Trust Company, since the $18,000,000 of debentures had not been placed in the treasury of Eastern Utilities Investing Corporation itself, nor retired, $35,000,000 of debentures were still listed as outstanding.[620]

Thus the accountants were enabled to compute asset coverage under the theory that there were only $16,506,000 principal amount of debentures outstanding but the Trustee was put in a position to demand the instruction of 15% of the full $35,000,000 principal amount of debentures before taking action.[621] Mr. Stix frankly admitted that the purpose of taking up the bonds in the name of a dummy corporation was "to straddle these two provisions in the indenture"—on the one hand to enable the accountants to present a colorable picture of compliance with the asset-coverage provisions of the indenture and to obstruct the debenture holders' right to call on the Trustee to enforce the covenants of the indenture should the violation become clear.[622]

As its own records showed $35,000,000 of debentures outstanding, the Trustee questioned the debt certificate issued by the Utility Accountants and Tax Consultants (which asserted that only $16,506,000 of debentures were outstanding) and demanded a new certificate.[623] No amended certificate was filed by the Company and the Trustee took no further action in connection with the asset coverage as of December 31, 1931.

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[620] Utility Accountants and Tax Consultants which had charge of filing annual certificate as to amount of the Company's debt was a Hopson service company (op. cit. supra, note 597, at 24763, and Commission's Exhibit No. 3782, Items 16, 17, 28, and 43).

[621] Op. cit. supra, note 619, pp. 233–8, 240–1, 456–8. Mr. Stix testified:

> There was a definition in the indenture in the sections which had to do with 150% and 125%, which defined outstanding bonds, and my understanding of those definitions was that as to the 125% and 150% covenants it applied to outstanding bonds which were not held in the treasury of Eastern Utilities Investing Corporation or in the treasury of a subsidiary company of Eastern Utilities Investing Corporation.
>
> As to the fifteen percent provision which had to do with action on the part of the trustee when requested by fifteen percent of the bondholders there was no such definition, and therefore there was a question as to whether or not fifteen percent meant fifteen percent of the thirty-five million which the Trustee had authenticated or whether it meant fifteen percent of the bonds outstanding either on the books of Eastern Utilities Investing Corporation, if that happened to be less than thirty-five million, or on a consolidated basis of Eastern Utilities Investing Corporation and a subsidiary.
>
> We took the position that in the absence of a definition we could seriously contend the fifteen percent applied to the thirty-five million that the Trustee had authenticated.
>
> * * * * * * *
>
> Well, in outlining the plan in the first instance that was the premise I started on, that they would find such a corporation and make it a subsidiary of Eastern Utilities Investing Corporation before they handled the transactions with respect to the exchanges. The sole purpose being to straddle these two provisions in the indenture or three provisions in the indenture.

[622] Id., pp. 233–8, 240–1.

[623] Op. cit. supra, note 597, Commission's Exhibit No. 3782, Item 66.

Not until June 15, 1932, did the Trustee, upon the advice of its counsel, call the attention of Eastern Utilities Investing Corporation to an "apparent" default under Section 14 of Article 3 of the indentrue, which required an asset coverage of 125% for the debentures.[624] The Trustee failed, altogether, to advert to another breach of the indenture which had undeniably taken place prior to this time, even if the $18,000,000 of debentures were not to be regarded as outstanding, namely, the payment of dividends on the preferred stock while the asset coverage was below 150%.[625]

Thereafter Eastern Utilities Investing Corporation proceeded with its debenture reacquisition program; but now the objective changed to the accumulation of enough debentures to remove from that instrument all provisions giving the debenture holders the right to call a default and effect a liquidation of the corporation upon any ground except non-payment of principal or interest. By May 12, 1933, the Associated system had reacquired enough debentures to be able to vote 85% of the total outstanding debentures even if the $18,795,000 of debentures held by the dummy subsidiary of Eastern Utilities Investment Corporation were disqualified.[626] From August 1932 to May 1933 General Finance Corporation, a subsidiary of Associated Gas and Electric Company, had been used as the agency to make the exchange offers. General Finance Corporation offered the Eastern Utilities Investing Corporation debenture holders the debentures of Associated Gas and Electric Company in exchange.[627] Throughout this period the officers, the bankers, and Eastern Utilities Investing Corporation itself, implied that the "touch-off" point had not been reached by asserting that:[628]

> The unprecedented decline in security values has made it apparent that an upturn in quoted values would be necessary to avoid such default.
>
> * * * * * * *
>
> We feel that the best interest of the debenture holders would be served by avoiding the default and its eventualities.

On May 12, 1933, the Associated Gas & Electric System having by that time reacquired enough bonds to assure the change in the indenture, Eastern Utilities Investing Corporation for the first time publicly announced the proposed amendments and in connection therewith baldly revealed that if the company had to be liquidated the holder of a $1,000 face amount of debenture would receive securities having a market value of only $85.28.[629]

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[624] Id., at 23821–3; Commission's Exhibit No. 3782, Item 58.

[625] Id., at 23825. A. M. Cooper, who was in charge of the indenture for the trustee, testified:

> Q. But you know that even on the basis of Eastern Utilities Investing Corporation's suggestion [via that $18,494,900 of the debentures were not to be deemed outstanding] a default would exist with respect to the requirement that 150% of assets be maintained?
>
> A. Well, yes; it was only, I believe, with reference to the payment of dividends.

[626] Id., Commission's Exhibit No. 3772, Item 39.

[627] Id., Commission's Exhibit No. 3826, and Commission's Exhibit No. 3772, Item 39.

[628] Id., Commission's Exhibit No. 3772, Item 39.

[629] Ibid.

Eastern Utilities Investing Corporation at this time had available for distribution to its debenture holders only securities of Associated Gas and Electric Company and its subsidiaries.[630] The character of some of the exchange offers by which the Associated Gas & Electric System had reacquired debentures of Eastern Utilities Investing Corporation is indicated by the fact that, included in the package of securities, of an aggregate market value of $85, which the holders of the $1,000 debenture would receive in liquidation, was $1,112.18 principal amount of Associated Gas and Electric Company 5% convertible obligations.[631] Only several months earlier General Finance Corporation had pressed upon the Eastern Utilities Investing Corporation bondholders a par for par exchange of $1,000 face amount of Associated Gas and Electric Company 5% convertible obligations for $1,000 Eastern Utilities Investing Corporation debentures.[632]

On May 12, 1933, Eastern Utilities Investing Corporation asked the Trustee to call a meeting of debenture holders for the purpose of amending the indenture in order to remove from it all provisions giving the Trustee or the debenture holders the right to call a default of such debentures upon any ground except non-payment of principal and interest.[633] The Trustee, who for more than a year had failed to take any action in connection with known breaches of the covenants of the indenture and had consistently declined to extend or vouchsafe information to the bondholders,[634] complied, forthwith, with the management's request and fixed the earliest possible date for the meeting.[635]

On June 22, 1933, the proposed amendments to the indenture were carried by a slight margin above the 85% vote required.[636] The $18,795,000 in principal amount of debentures held by Southwestern Utilities General Corporation, the subsidiary of Eastern Utilities Investing Corporation, was disqualified from voting. But the debentures held by the Associated Gas & Electric System, upon which the management depended to carry the amendments, were permitted to vote in the face of a protest by the Tradesmen's National Bank and Trust Company of Philadelphia, a holder of $25,000 face amount of debentures, based on the provisions of the indenture disqualifying debentures held for the benefit of the issuer.[637] The inspectors of the votes, appointed by the Trustee, supported by the opinion of counsel

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[630] Eastern Utilities Investing Corporation announced on May 12, 1933, that the holder of a $1,000 debenture would receive upon immediate liquidation the following securities having an aggregate market value of $85:

7 shares General Gas and Electric Corporation Class A common stock; 4.9 shares Associated Gas and Electric Company $5 dividend series Pfd. Stk.
9.4 shares Associated Gas and Electric Company $4.00 Cum. Pfd. Stk.
5 shares Associated Gas and Electric Company $6.50 Cum. Pfd. Stk.
$1,112.18 principal amount Associated Gas and Electric Company 5% Conv. obligations.
$13.90 principal amount Associated Gas and Electric Company 7% interest bearing scrip due February 15, 1939 (ibid.).

[631] Op. cit. supra, note 597, Commission's Exhibit No. 3772, Item 39.

[632] Id., at 25998–9.

[633] Id., at 23852–7, and Commission's Exhibit No. 3782, Item 94.

[634] Id., at 23747, 23753, and Commission's Exhibit No. 3782, Items 50, 52, 55, 58, 59.

[635] Id., Commission's Exhibit No. 3771, Exhibit G, Art. XII, Sec. 2 (p. 68).

[636] The actual vote in favor of the amendments was $13,803,000 in principal amount of debentures, or slightly in excess of 85% (id., at 23384–5).

[637] Id., at 23388, and Commission's Exhibit No. 3782, Item 8.

for the trustee, rejected the protest.[638] The protesting bank did not have the benefit of an insider's knowledge of the affairs of the system nor the benefit of an examination of the books and records of Eastern Utilities Investing Corporation nor of the books of affiliated companies to trace the reacquisition of these bonds.[639] In the last analysis it was the reacquisition program prosecuted by the Associated Gas & Electric system which enabled the "System" to effect the ultimate elimination of practically all of the safeguards originally contained in the indenture.

In October 1936 Eastern Utilities Investing Corporation went into reorganization proceedings under Section 77B of the Bankruptcy Act.[640] The reorganization plan, which apparently contemplated a liquidation of the company by means of an offer to minority security holders to exchange their securities for securities of Associated Gas and Electric Company was ultimately approved by the Court.[641]

The history of the $35,000,000 debenture issue of Eastern Utilities Investing Corporation shows that the fate of bond issues—allegedly the most conservative and best protected of the various types of senior securities distributed by the multiple-security investment company—may be almost wholly at the mercy of the management, which may succeed in reacquiring the securities from the hands of the holder on the basis of almost any exchange which it chooses to promote and can easily restrain the holder from exercising the contingent privileges granted to him.

c. Issuance of Additional Bonds and Notes and the Contracting of Bank Debts [642]

One of the major weaknesses of present safeguards for investment trust bondholders is the opportunity frequently afforded an unprincipled or improvident management to issue additional bonds and notes or contract bank debts taking precedence over the right of existing debentures or receiving an equal priority with the existing debentures.

Many debenture issues have, no doubt, been sold under representation, true when made, that the particular issue has an exclusive first claim on the assets of the company. However, of 48 investment company and investment trust indentures, examined,[643] 15 had no specific limitation upon the amount of funded indebtedness that might be outstanding at any one time, while 33 indentures specified a maximum indebtedness that might be created under the particular

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[638] Id., at 3380.

[639] Mr. Cooper testified (id., at 23887):

> Q. In order to obtain ample evidence to determine whether or not the debentures held within the Associated Gas & Electric system were held for the benefit of Eastern Utilities Investing Corporation, or held by or for the benefit of a subsidiary of Eastern Utilities Investing Corporation, it would have been necessary, would it not, to examine various books of account and other records of system companies? And to examine witnesses as to the beneficial ownership of certain securities? Isn't that right?
> A. Yes, sir.

[640] Id., Commission's Exhibit No. 3783.

[641] Ibid., and *Wall Street Journal,* August 4, 1939.

[642] See supra, pp. 1775–89.

[643] Upon examination of the answers to the questionnaire submitted by 180 investment companies, it was found that 33 of these companies had issued bonds or debentures and that these 33 companies had issued in all 48 separate issues of bonds and debentures.

funded issue.[644] Of the 33 investment trusts and investment companies which were found to have issued bonds or debentures, 29 executed such indentures as permitted the issuance of subsequent debentures provided a certain ratio of assets to indentures existed after the issuance of the additional debentures, while the indentures of four companies failed even to contain a negative pledge clause, that is, a provision requiring the presence of a certain ratio of assets for the issuance of additional debentures.[645] The holder of a debenture of an investment company, which is secured by a pledge of property only in the minority of cases, is thus generally unprotected against the future issue of bonds, notes, and current debts that can be placed ahead of his debenture. Short-term loans may be contracted or new debentures issued with an earlier date of maturity so that the later obligation of the company will become entitled to payment before the first issue of debentures; or by reason of a default in payment of interest on subsequent debentures, these debentures may cause a liquidation of the company when the original debenture holders are not in favor of liquidation.

If an investment company encounters financial difficulties, caused either by a period of declining security values or by the activities of inexpert managements, the company may resort either to the issuance of additional securities or borrowings from banks in order to realize additional cash to extricate itself from its predicament.

The issuance of additional bonds or debentures has not been so prolific a source of injury to the debenture holders as the contracting

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[644] The limitations upon the amount of funded indebtedness that might be created under the specified issues were as follows:

American General Corporation (International Securities Trust of America)	$40,000,000
Adams Express Co., The:	
No. 1	24,000,000
No. 2	12,000,000
Aldred Investment Trust:	
No. 1	5,000,000
No. 2	5,000,000
American European Securities Co.:	
No. 1	2,000,000
No. 2	2,000,000
American International Corporation	25,000,000
Capital Administration Company, Ltd	20,000,000
Carriers and General Corporation	5,000,000
Continental Securities Corporation	5,000,000
Domestic & Foreign Investors Corporation	2,500,000
General American Investors Co., Inc	7,500,000
General Investment Corporation	6,091,200
Investors Equity Company, Inc.:	
No. 1	20,000,000
No. 2	20,000,000
New York & Foreign Investing Corporation	6,000,000
Niagara Share Corporation of Maryland	15,000,000
North American Investment Corporation	5,000,000
Overseas Securities Co., Inc	3,500,000
Public Utilities Corporation	600,000
Railway and Light Securities Company:	
No. 1	500,000
No. 2	1,000,000
No. 3	1,000,000
No. 4	3,000,000
No. 5	4,000,000
Reynolds Investing Company, Inc.:	
No. 1	10,000,000
No. 2	10,000,000
Standard Investing Corporation:	
No. 1	4,500,000
No. 2	5,000,000
Tri-Continental Corporation	20,000,000
Western Reserve Investing Corporation	3,000,000

[645] These four companies were Old Colony Investment Trust, Old Colony Trust Associates, Tri-Continental Corporation, and Union American Investing Company.

of "short term" or "temporary" liabilities which are not included within the modicum of protection furnished by the fairly common "negative pledge clause" in connection with the issuance of additional debentures. Among the 48 indentures of investment trusts and investment companies examined, no instance was noted of a specified pecuniary maximum for temporary indebtedness. In several instances the indenture contained a minimum asset ratio for all indebtedness—a provision that the contracting of temporary indebtedness be limited to a specified percentage of the net resources or that a specified margin of assets above all indebtedness be constantly maintained.[646] Several indentures provided that the company would not mortgage or pledge or create any lien on any of its assets as security for temporary indebtedness unless the "current resources" of the company exceeded the funded indebtedness by a specified percentage.[647] One of the most important phases of the general problem of inadequate safeguards for senior securities concerns the absence of restrictions upon the pledging of assets for temporary indebtedness and for bank borrowings on the part of the investment trust or company entailing the hypothecation by the company with the bank of the most desirable or marketable of its portfolio securities in order that the loan be consummated.[648]

The indebtedness which American Bondholders & Share Corporation contracted is an example of bank borrowing prejudicial to the holders of the outstanding debentures of that company.

(1) AMERICAN BONDHOLDERS & SHARE CORPORATION

American Bondholders & Share Corporation, a closed-end management investing company, was organized on September 12, 1927, under the laws of Delaware under the principal sponsorship of Myron S. Hall & Co., members of the New York Stock Exchange.[649] The capital stock of this company consisted solely of 10,000 shares of common stock of no par value, issued to the sponsors at $5 per share

[646] For example, the indenture for the 5% gold debentures of International Securities Corporation of America provided both that no temporary indebtedness be created, if upon the creation thereof the total outstanding temporary indebtedness would exceed 10% of the company's current resources (Public Examination, American General Corporation et al., Commission's Exhibit No. 3401, Indenture, Sec. 31), and that the current resources of the company should at all times be equal to at least 125% of the principal amount of all indebtedness, funded and temporary (id., Sec. 39).

The indenture for the 5% series B debentures of Investors Equity Company, Inc., provided that the net assets should at all times be equal to at least 140% of all funded indebtedness and 110% of all indebtedness.

[647] For example, the indenture for the 5% gold debentures of International Securities Corporation of America provided that the company should not mortgage, pledge, or create a lien on any of its assets as security for any temporary indebtedness unless the current resources of the company equaled at least 200% of the aggregate funded indebtedness (Public Examination, American General Corporation et al., Commission's Exhibit No. 3401, Indenture, Sec. 31).

[648] An example of the jeopardizing of the preferred stockholder's position through the contraction of an indebtedness to banks which was given a prior lien on the assets of the company is to be found in the story of The Equity Corporation bank loans given, supra, pp. 1775–9.

[649] *Moody's Manual of Investments, Banks, etc.* (1929), p. 2810. Participating in the sponsorship of this investment company was the investment banking and brokerage firm of O'Brian, oPtter & Stafford, of Buffalo, New York (ibid.).

[650] Derived from supplementary information supplied the Commission for American Bondholders & Share Corporation.

for a total of $50,000.[650] The public's contribution was obtained through the issuance of debentures in the principal amount of $1,000,000.[651] Absolute control of $1,000,000 of the public's funds was obtained by the insiders with an investment of $50,000. Contrasted with the public's funds, the sponsor's contribution was relatively insignificant and provided a very small cushion for the senior securities. To a limited extent the debentures were accorded participation in earnings and surplus profits of the company.[652] The maturity date of the debentures was in the year 2027, a hundred years from the date of issue.[653]

The absence of protective features marked this issue of senior securities. The debentures were unsecured, had no "touch-off" clause, and had no requirement that the debentures be equally and ratably secured if any assets of the company be pledged to secure other indebtedness.[654] The only restriction with respect to incurring additional indebtedness was a covenant that the company would not create an issue of funded debt (defined as a liability created through the sale of securities maturing in more than one year), unless asset coverage for all liabilities exceeded 105%.

The investment company was not unsuccessful in its early years. As at December 31, 1929, despite the market break of that year, the debentures were fully covered and a slight excess in asset coverage existed. Thereafter, the decline in the value of the company's portfolio securities continued relentlessly. During this period, the investment company borrowed cash from banks upon the pledge of portfolio securities in order to purchase additional securities at the current low market levels apparently with the view of hedging its unrealized depreciation losses. These loans reached a maximum of $240,000 during 1931.[655] The pledging of the portfolio assets for the company's borrowings constituted the lending banks secured creditors to whom the debenture holders, unsecured as they were, were subordinated. Moreover, since the continued decline of the market value of the collateral necessitated the submission of additional collateral, more and more of the assets of the company were removed from the first claim of the debenture holders and subjected to the secured claim of the banks. At December 31, 1930, the market value of the investment company's portfolio securities was approximately $818,000. Of these, securities with a market value of $307,000 were pledged as collateral to secure bank loans aggregating $210,000.[656] One year later, December 31, 1931, the company's total investments had a market value of only $320,000 and securities worth $262,000 were pledged to secure loans of $185,000.[657] Thus, the percentage of the market

[651] Ibid.

[652] In addition to a fixed-interest rate of 4½% the debentures had certain participating rights. Each $1,000 face-amount debenture carried 10 nondetachable security receipts. Coupons applicable to these receipts entitled the debenture holder to cumulative interest up to 1½% if earned prior to payment of dividends on the common stock and, in addition, if common-stock dividends exceeded $1 per share, a sum equal to 150% of such dividends. At maturity the debenture holder was entitled to receive three-fifths of the book value of a share of common stock for each security receipt. (*Moody's Manual of Investments, Banks, etc.* (1929), p. 2810.)

[653] Ibid.

[654] Op. cit. supra, note 650.

[655] Ibid.

[656] Ibid.

[657] Reply to the Commission's questionnaire for American Bondholders & Share Corporation and supplementary information.

value of the portfolio securities pledged to secure the loans increased from 37% to 82% in the space of a year.

The course pursued by the directors of the investment company, in effect the purchase of stock on margin, proved to be disastrous. While the volume of portfolio holdings of the company increased steadily from 1930 to the end of 1931, the market price of these investments steadily depreciated. During the year 1932, when market prices were still falling, the bank loans were called and the pledged securities were sold. The management had exposed the company's capital to hazards, and the results of the unsuccessful speculation now redounded to the injury of the debenture holders. The investment company sustained a comparatively enormous realized loss—over $980,000. The investment company was left with only $42,575 total assets at the end of 1932. The bulk of the loss, of course, was borne by the debenture holders. In January 1933, when it was decided to liquidate the assets of the company, the holder of each $1,000 debenture was offered $41 in cash or a share of common stock in a new corporation organized under the laws of New York and sponsored by Cohn Brothers, the successor of Myron S. Hall & Co. Two-thirds of the debenture holders accepted the cash offerings—96% less than the face amount of their debentures.[658]

d. Diversification in Portfolio

Perhaps the most significant characteristics of management investment companies are that their assets, to a far greater extent than those of other types of companies, are liquid or readily marketable and that the broadest powers of investment are conferred upon management. The nature of the investments can vary greatly and can be shifted rapidly. The company's funds may be invested in comparatively small blocks of diversified securities of various classes in various industries or may be invested in concentrated blocks giving a position of control or influence in a variety of industries. The funds of the company may be and have been employed in underwritings, commodity purchases, in loans to others, foreign exchange or other investment companies, or to promote a variety of business enterprises. The funds may be employed in long-term investments or speculative trading activities. Since the exercise of these broad powers by a reckless or self-serving management may constitute an obvious threat to the interest of the bondholders, investment companies have, although very infrequently, purported to extend to the bondholders protection against excesses of such a nature by including in the indenture covenants limiting the scope of the management's discretion.

Covenants of this nature, like the "touch-off" provision and other alleged safeguards extended bondholders, have not been immune from circumvention by the management. Bondholders, as a class, generally receive no participation in the management; hence the administrators of the investment company may be ready to accept specious reasoning and tenuous interpretations of these protective provisions

[658] Derived from supplementary information supplied the Commission for American Bondholders & Share Corporation. The dissolution of the company and the distribution to debenture holders was consummated in March 1933 (*Moody's Manual of Investments, Banks, etc.* (1933), p. 1595).

in order to eliminate obstacles to a course of action favorable to management interests or to the other classes of securities. The trustee may fail to take any action, of its own motion, to secure compliance with the covenants, and rarely can the requisite proportion of bondholders be assembled to compel the insistent and continuous action on the part of the trustee which is necessary to enforce a default or breach of covenant.

(1) PACIFIC SOUTHERN INVESTORS, INC.

Illustrative of the circumvention or possible violation of a provision in an indenture restricting the scope of management discretion, and of the failure of the trustee to take any action in regard thereto, is Pacific Southern Investors, Inc.

Pacific Southern Investors, Inc. was a member of the group of four management investment companies so closely related in sponsorship and interownership of stock that they have ordinarily been identified by the name of the company which at the time appeared to be the most significant one in the group—first known as the American Capital Group and subsequently as the Pacific Investors Group.[659] Two members of the group, Pacific Investing Corporation and American Capital Corporation, were organized in 1927 and 1928, respectively, by a group of Los Angeles businessmen headed by Henry S. McKee, at the time president of Barker Bros.; [660] the other two, The Investment Company of America and Southern Bond & Share Corporation, were sponsored in 1926 and 1928, respectively, by E. E. MacCrone & Co., a brokerage firm in Detroit.[661] Jonathan B. Lovelace, a partner in E. E. MacCrone & Co., and thus involved in the organization of the MacCrone companies, participated also in the formation of American Capital Corporation.[662]

In 1930, as a result of an exchange program and some cash purchases of stock, American Capital Corporation acquired 85.7% of the common stock of Pacific Investing Corporation and, as that stock had the sole voting power, secured absolute voting control of the latter company.[663] In April 1932 American Capital Corporation brought about the merger of Southern Bond & Share Corporation, which had been organized by the MacCrone group, with Pacific Investing Corporation into a new investment company which was called Pacific Southern Investors, Inc.[664] Later in 1932 the Los Angeles group, headed by Henry S. McKee, as noted above, and Jonathan B. Lovelace, who had had some friction with Mr. MacCrone [665] and had played a progressively larger part in the affairs of the Pacific Coast companies, consummated a plan pursuant to which E. E. MacCrone & Co. yielded up its control of The Investment Company of America to Mr. McKee and Jonathan B. Lovelace and their associates, and The Investment Company of America acquired the control block of stock of

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[659] Reply to the Commission's questionnaire for Pacific Southern Investors, Inc., Pt. IV, Item 21.

[660] Public Examination, American Capital Group, at 7046, 7060, 7080–1, and 7103.

[661] Id., at 6995, 7001–2, 7040, 7042–3, and Commission's Exhibit No. 667.

[662] Id., at 7062.

[663] Id., at 7356 and 7360.

[664] Id., at 7310, 7362, and Commission's Exhibit No. 686.

[665] Id., at 7263, 7285, 7293 and 7329. Mr. Lovelace left the firm of E. E. MacCrone & Co. in September 1929 (id., at 7329 and 7320).

American Capital Corporation.[666] Thus, by August 1932 Henry S. McKee and Jonathan B. Lovelace and their associates controlled all four of the investment companies: The Investment Company of America, which was a Michigan business trust,[667] under the terms of the organic instrument; American Capital Corporation, through The Investment Company of America; and Pacific Southern Investors, Inc. (the product of the merger of Pacific Investing Corporation and Southern Bond & Share Corporation), through American Capital Corporation.[668]

Although now vested with the control of the three other companies, the new management of The Investment Company of America was faced with the absence of any provision for compensation to management in the existing structure of The Investment Company of America, which was not a corporation but a Michigan business trust.[669] A capital readjustment was thereupon effectuated pursuant to which a new corporation of the same name (The Investment Company of America) was organized to take over the assets of the Michigan trust.[670] The new corporation entered into a contract with a management concern headed by Jonathan B. Lovelace and his associates,[671] and Pacific Southern Investors, Inc., furnished $946,350 of new capital by buying 45,000 shares, equivalent to 45.8%, of the common stock of the new corporation.[672] At this time Pacific Southern Investors, Inc., had $3,480,000 of 5% debentures outstanding.[673] These debentures had been originally issued under an indenture dated January 1, 1928,[674] by Pacific Investing Corporation, a predecessor of Pacific Southern Investors, Inc., in the face amount of $5,000,000.[675] Prior to the merger of Pacific Investing Corporation into Pacific Southern Investors, Inc., in 1932[676] the predecessor company had purchased and retired $1,520,000 face amount of debentures of Pacific Southern Investors, Inc., assumed the remaining $3,480,000,[677] and subsequently repurchased $76,000 of the debentures, thus leaving $3,404,000 outstanding in the hands of the public and $76,000 in the company's treasury by June 30, 1933.[678]

The indenture under which the debentures were issued carried a number of covenants restricting investment of the corporation's funds.[679] The indenture provided that the corporation make no investment: (a) in real estate; (b) which involved promotion or management on the part of the corporation of other enterprises; (c) in any corporate stock or other security which represented participation in the business risk of any new and unproved enterprise; (d) in any security about which reliable information was not available with

[666] Id., at 7275, 7291, 7366–7, and 7381.
[667] Id., at 7381.
[668] Ibid.
[669] Id., at 7001.
[670] Op. cit. supra, note 659, Pt. IV, Item 21.
[671] Op. cit. supra, note 660, at 7403.
[672] Id., at 7389 and op. cit. supra, note 659, Pt. IV, Item 21.
[673] Op. cit. supra, note 659, Pt. I, Exhibit V.
[674] Id., Pt. I, Exhibit KK.
[675] Ibid.
[676] Id., Exhibit A—Joint Agreement of Merger.
[677] Id., Pt. I, Exhibit S.
[678] Id., Pt. I, Exhibit T.
[679] Id., Pt. I, Exhibit KK (pp. 34–5).

respect to history, management, earnings, and income of the governmental authority, corporation, or organization issuing the same. The indenture also contained a categorical prohibition against the investment of more than 5% of the assets of the company in the securities of any one corporation or other organization.[680] The Company covenanted that it would make no investment:

(e) If the investment would cause more than five percent (5%) of the assets of the Company as it exists at the time of the investment to be invested in the securities of any one corporation or other organization.

The $946,350 which Pacific Southern Investors, Inc., invested in The Investment Company of America in 1933 to assist the latter in effecting its plan of capital readjustment represented approximately 15% of the assets of Pacific Southern Investors, Inc. at that time.[681]

Inquiry had been made of Dykema, Jones & Wheat, a law firm, which the president of the company characterized as "independent counsel," whether the investment would violate the provision of the indenture forbidding the investment of more than 5% of the company's assets in the securities of any one corporation or any other organization.[682] Counsel advised, in effect, that if the prohibition were to be construed in the light of its purposes, namely, to assure distribution of risks, then the investment of 15% of the company's assets in another general management investment company whose charter prescribed similar investment limitations would not be held to violate the prohibition; but if, on the other hand, the prohibition were strictly and literally construed, a contrary conclusion might be reached.[683] The opinion emphasized, moreover, the difficulties of securing joint action from the required proportion of debenture holders, and suggested that the difficulties and delay involved in getting the trustee to act, even if the transaction constituted a violation, would allow the company "an extended period in which to withdraw the investment, with resulting probable ability to so withdraw without loss to your shareholders."[684] The opinion of counsel constitutes an

[680] Id., Pt. I, Exhibit KK (pp. 30 and 34–5).

[681] Op. cit. supra, note 660, at 7394.

[682] Ibid., ; and Federal Trade Commission, Docket Section, File 2–948–3, telegram of Henry S. McKee, president, Pacific Southern Investors, Inc., dated July 5, 1934.

[683] Federal Trade Commission, Docket Section, File 2–948–3, Correspondence—copy of letter of Dykema, Jones & Wheat to Pacific Southern Investors, Inc., dated September 30, 1933.

[684] Ibid.; counsel's opinion reads in part as follows:

The Company, which is the subject of the intended investment, is an investment trust of the general management type. Its Charter contains a series of investment restrictions generally similar to the restrictions in your Debenture Agreement.

Its investments are now, and have always been, widely diversified. Therefore, disregarding the fact that your interest in the subject company's assets will be indirect, your investment will actually place at risk in any single item held by the subject company only a very small percentage of your total assets.

Under the agreement of Purchase, three of a Board of seven directors of the subject company are to be named by your company, in addition to Mr. Lovelace, who is already a director of both. This majority representation will apparently continue and involves definite assurance of your ability to influence investment policy of the subject company. Therefore, in addition to a present wide distribution of the actual risks pertaining to your investment, there is assurance of continued wide distribution of such risks in the future.

The purpose of the five-percent restriction is plainly to gain for debenture holders the protection which results from distribution of risk over a number of investments. If the restriction is to be interpreted and applied in the light of its purpose, then, in view of the assured distribution of actual risks of the present investment, it should be held not to violate the restriction. If, on the other hand, the restrictive language is to be strictly and literally construed, a contrary conclusion would be reached, because your investment will be made through the medium of a purchase of stock on "one corporation." The question, then, is squarely whether the provision is to be construed

excellent exposition of the difficulties in the way of procuring compliance with covenants in indentures and in the way of securing action in case of defaults on the part of the company.

Counsel argued that the management was justified in making the investment in the light of its belief that the debenture holders would share its views of the beneficial character of the investment.[685] It should be noted that the indenture specifically provided for a contin-

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primarily with reference to its purpose, or with reference only to the exact and literal meaning of the language.

* * * * * * *

We turn now to the question of an attacking party's remedy. If holders of ten percent of debentures request the Trustee to give notice of default, it becomes the Trustee's duty to do so. Agreement and unity of action by holders of ten percent of debentures is required. Passing any question of the difficulties of any interested debenture holders bringing the facts to the attention of others, it seems to us extremely unlikely that any group large enough to hold ten percent (assuming individual ownerships in customary amounts) could be brought into agreement upon the impropriety of the purchase in question. It is extremely improbable that any notice would be issued by the Trustee without opportunity to you to discuss the matter with complaining parties. If they were advised of your reasoning in favor of the investment and of the fact of additional capital, exceeding the amount involved in the purchase, being placed behind their debentures through the merger, it is unlikely that anyone would persist in complaint except, possibly, for some person of trouble-making type.

If, however, our estimate of the view of the average debenture holder proved incorrect and ten percent did join in complaint, the following language would then come into play, namely:

> "The Trustee may, and upon the request in writing of thirty percent (30%) of the principal amount of the debentures * * * shall * * * declare * * *"

the debentures to be due and payable. You will observe that after the first step, based upon action of ten percent of the debenture holders, the Trustee is authorized, but not required, to take the second step upon request by holders of thirty percent. It is a reasonably safe conclusion that a Trustee requested for action upon the basis of a more or less technical default, which is neither substantial nor violative of a principal protective provision of the document, will demand the stipulated thirty percent. In other words, it is hardly conceivable that a Trustee would act on its own motion except where the default is plain and substantial. If there is any ground whatever for our view expressed above, that no group holding ten percent could be induced to act unanimously on this proposition, it would seem quite certain that no group representing thirty percent would ever so act. Again, we are not referring to the difficulties of bringing the facts to the attention of scattered debenture holders, but to the supposed views of a group of reasonable individuals after the facts were presented.

If the view with respect to thirty percent should prove incorrect and an adverse declaration of the Trustee occurred, and if the necessary indemnity against costs were provided to the Trustee, it might bring suit. At any time prior to final judgment in such a suit the default can be cured under the language at the end of Section 46. This alleged default could be cured by sale of the particular investment. It follows from this fact that the attacking parties would be carrying the burden and expense of their proceedings with no possible victory except to force sale of the particular investment if you decided upon such sale at any time during the extended period which would be consumed in preliminary proceedings and litigation. Again, the probabilities of the matter register strongly in our minds. It is hardly conceivable that any group of debenture holders would wish to carry on a somewhat elaborate proceeding against you on the basis of so unsubstantial a complaint, and so uncertain and inconsequential a result to be gained by victory.

In calling attention at some length to the remedies of debenture holders, we do not imply that the management's observance of obligations is to be controlled by difficulties which may stand in the way of debenture holders enforcing their rights. You are entitled, however, to take note of the fact that the provisions of the Debenture Agreement which deal with a default of this character, allow for discussion before change of the debtor's position, and for curing of default at any time before final decision by a court. We can see no reason why, in final decision upon your course, you should not take note of the opportunity of persuading any objecting debenture holders to your view and, failing this, of the opportunity of withdrawing from the investment.

To summarize our views we say, First, that there is strong probability that the five-percent restriction would be construed in the light of its purposes with a resulting holding that the proposed investment is no violation thereof. In reaching this opinion we do not deny force to a counter argument based upon a strict and literal construction of the language nor the possibility that it would prevail. Second, you are justified, in the light of your own informed opinion that the investment is beneficial to the fund and consistent with the protection designed to be afforded debenture holders, to make the investment in the belief that debenture holders would share your views, and, Third, that the necessary course of proceedings, in the event some large group of debenture holders held a view contrary to your own, is such as to allow you an extended period within which to withdraw from the investment, with resulting probable ability to so withdraw without loss to your shareholders.

[685] Federal Trade Commission, Docket Section, File 2–948–3. Opinion of Counsel.

gency where the restrictions might stand in the way of operations beneficial to the company as a whole. Article VI, Section 53, of the debenture provided as follows:[686]

Except as otherwise expressly provided herein, the holders of 75% in principal amount of all debentures issued and outstanding under this Agreement may, at any time, with the consent of the Company, for whatever reasons to them may seem sufficient for the purpose of further securing the payment of such debentures or for the purpose of assisting the Company in the conduct of its business, or for such other purpose as may be deemed by such holders sufficient, alter or modify any provision, term, condition, agreement, or covenant of this Agreement, * * *.

Such action shall be taken by the holders of debentures by the affirmative vote of the holders of 75% in amount of all debentures issued and outstanding hereunder at a meeting of the debenture holders called for that purpose as hereinafter provided, or by an instrument or instruments in writing as hereinafter provided.

Debentures owned by the Company, or by a nominee of the Company, shall not be deemed to be issued and outstanding for any purposes of this Article.

It may thus be seen that provision was obviously made for a method of ascertaining whether the debenture holders approved a departure from the restrictive provisions of the indenture.

The circular advertising the 5% debentures, published in January 1928, drew the attention of prospective purchasers to the fact that the Certificate of Incorporation provided that not more than 5% of the corporation's assets might be placed in any one security, firm, or corporation. The Joint Agreement of Merger, dated March 21, 1932, preserved the 5% limitation intact. However, in April 1933, several months prior to the transaction with The Investment Company of America, the Joint Agreement of Merger was amended to read as follows:[687]

Not more than five percent (5%) in value of the assets of the corporation shall be invested in any one stock or other security, or in securities issued by any one corporation, syndicate, association, trust, firm, or individual, except that an amount not exceeding twenty percent (20%) of the value of the assets of the corporation may be invested in the security or securities of one or more financial companies or investment trusts—the term "financial companies" to include holding, trading and/or underwriting companies and other similar businesses, and the term "investment trust" to include corporations and/or trusts organized to conduct the business of a general investment trust.

The exception introduced by the amendment seems calculated to foreshadow just such a transaction as the investment of more than 5% of the company's assets in The Investment Company of America. This attempt at enlargement of the management's discretion was not adverted to in the reply of counsil, due, undoubtedly, to the recognition by counsel that the contractual obligations of the company to the debenture holders could not be diminished by amendment of merger agreements or certificates of incorporation not formally asquiesced in by the requisite proportion of debenture holders.

No question concerning the conflict of this investment with the terms of the indenture was raised at any time by the Merchants

[686] Op. cit. supra, note 659, Pt. I, Exhibit KK (pp. 51–2).

[687] Id., Pt. I, Exhibit A (p. 8).

National Trust and Savings Bank of Los Angeles,[688] the trustee under the indenture, nor by the bankers, Bonbright & Co. and Blyth & Co., who had floated the corporation's 5% bonds.[689] As far as has been ascertained, no issue was made of this transaction until, in June 1934, Pacific Southern Investors, Inc., sought to register with the Federal Trade Commission (which at that time administered the Securities Act of 1933) its preferred shares, Class A common, Class B common, and warrants which Pacific Investors, Inc., a newly formed holding company, proposed to purchase from American Capital Corporation.[690] In connection with this registration statement, the Federal Trade Commission drew the attention of the company to the fact that [691]

> Your purchase of forty-six percent interest in the stock of Investment Company of America may have been contrary to the provisions of the debenture agreement underlying your present outstanding debentures. You are requested to advise the Commission fully concerning this matter; and if you have secured counsel's opinion in regard to such transactions, to furnish the Commission with a copy of such opinion.

The Securities Division of the Federal Trade Commission found that the opinion itself indicated a doubt as to whether the investment did not constitute a violation of the terms of the debenture agreement, and that under the circumstances "it would appear to be a material omission not to reveal this fact in the prospectus." The Commission suggested that "the prospectus be amended to include a discussion of this matter, prior to its use in the solicitation of subscriptions." [692] The registrant thereupon filed an amendment to the prospectus incorporating information in connection with the investment in the securities of The Investment Company of America.[693]

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[688] E. J. Nolan, director of Pacific Southern Investors, Inc., was president of Merchants National Trust and Savings Bank of Los Angeles when Pacific Investing Corporation issued the bonds in 1928.

[689] Op. cit. supra, note 660, at 7395.

[690] Federal Trade Commission, Docket Section, File 2–948–3.

[691] Id., correspondence—letter dated July 5, 1934.

[692] Id., correspondence—letter dated July 12, 1934.

[693] Id., correspondence—letter of Bureau of Securities Division, dated July 16, 1934. The characterization of the firm of Dykema, Jones & Wheat as independent counsel (Public Examination, American Capital Group, at 7394) was perhaps not wholly justified. Dykema, Jones & Wheat, while not regular counsel for Pacific Southern Investors, Inc., had been counsel for The Investment Company of America from the inception of that company (id., at 7394). Moreover, the firm had rendered legal services to The Investment Company of America in connection with the plan or recapitalization which involved the very investment of $946,350 by Pacific Southern Investors, Inc. (id., at 7395). In addition, Mr. Dykema of that firm served as a trustee for The Investment Company of America (id., at 7250, 7394, 7395). J. B. Lovelace testified (id., at 7394–5):

> Q. I think that you said that that was the opinion of independent counsel, at the time.
> A. Mr. McKee referred to it as independent counsel.
> Q. That was the Detroit firm of whom Mr. Dykema was a former trustee?
> A. Yes.
> Q. So that while they were independent in the sense that perhaps they weren't house counsel, they were very intimately connected with the picture, were they not, and had been for years?
> A. They were interested in The Investment Company of America.
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> * * * * * * *
>
> Q. Did they do the other legal work in connection with the plan of recapitalization?
> A. Yes.

e. Bonds or Debentures in Open-End Companies

In addition to the complexities and conflicts, generated by bonds in the structures of investment companies which have already been described, the existence of bonds or debentures in the capitalization of open-end companies creates problems which flow from the characteristic feature of this type of company—the right of one or more classes of security holders to compel the company at any time to redeem their securities at their approximate asset value.[694]

In this type of company the difficulty of the bondholders' position is accentuated by the fact that the company's investments are predominantly made in listed common stocks because of the necessity for liquidity to meet redemptions and because of the sales appeal of a common stock portfolio.[695] Moreover, where the open-end company has also issued bonds, a portfolio of common stocks will accelerate the leverage in the common stocks issued by the open-end company.[696] In other words, the nature of the portfolio of the open-end company, since it rarely includes securities of relatively stable values such as bonds and preferred stocks, gives a minimum of security to the bondholders against extreme fluctuations in the value of the corporate assets.

As a consequence of these characteristics of open-end companies, unless their debentures contain adequate "touch-off" clauses and other protective provisions, the position of the bondholders may readily become precarious because the "cushion" for the debenture holders, that is, the value of the corporate assets over and above the face value of the company's outstanding debentures, may be entirely eliminated by redemptions of the common stockholders. When market values of portfolio securities are declining, redemptions will be likely. Redemptions by common stockholders may be accelerated by the proportionately greater decline, as compared with the decline in general market values of securities, in the asset values of the common stock caused by the leverage induced by the presence of bonds in the capital structure. In other words, the existence of the bonds themselves will contribute to a more rapid elimination of the "cushion" of equity assets which previously existed for such bonds.

If, in addition to the absence of adequate "touch-off" provisions the bondholders are denied a right to redemption, their problems may become extremely complex. In a period of falling market values for portfolio securities, a wholesale liquidation of the company's assets may be required in order to derive funds to meet redemption by the

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[694] For a detailed discussion of the open-end company, see Ch. III of this part of the report, pp. 799 et seq.

[695] Ibid.

[696] A circular issued by Affiliated Fund, Inc., one of the few open-end companies with bonds in its capital structure, states (Reply to the Commission's questionnaire for Affiliated Fund, Inc., Pt. I) :

> We believe it is right to recognize frankly that the purchaser of ACES, the common stock of Affiliated Funds, Inc., is primarily interested in price action rather than in any of the other investment factors. The investor turns to the straight mutual fund for income and for appreciation possibilities that reflect the general market trend. He turns to ACES for action. By and large, leverage means faster movement, whether in rising and falling markets. If it is truly an American trait to want faster movement, the American investor will respond to the suggestion of having a block of ACES in his security holdings.

common stockholders. The most readily salable portfolio securities will presumably be liquidated first. As a result, the assets remaining to satisfy the claims of the bondholders may consist of the least marketable portfolio securities, and these assets may ultimately prove insufficient to meet the claims of bondholders. The security holder of the category which has invested on the basis of securing preferred position and safety will then be left with recourse only to a questionable right of recovery of assets from a large and geographically widely dispersed group of common stockholders who have had their shares redeemed.

Even where the bondholders as well as the stockholders have a right to compel redemption of their securities, similar difficulties may arise.[697] With a decline in the value of the corporate assets a race for redemption may ensue. Those bondholders and stockholders who are most alert and who redeem first will receive the value of their securities out of the most liquid and easily salable portfolio securities. As a consequence, the claims of the remaining bondholders will be redeemable only against portfolio securities of more doubtful value and least marketability. Again, if the remaining assets of the company ultimately become insufficient to meet the claims of unredeemed bonds, the bondholder will be relegated to a very doubtful right of a recovery of this loss from the other bondholders, who in effect had obtained preferential treatment, and the stockholders who have redeemed their shares.

Furthermore, the construction of sound protective provisions which effectively secure the interest of bondholders in an open-end company and are at the same time consonant with the right of common stockholders to redeem their securities is difficult.[698] For example, at the point of incidence of a "touch-off" clause the protection of the bondholder may require a cessation of the redemption privilege of the common stockholder or a complicated and cumbersome process of attempting to decrease the amount of outstanding bonds as redemptions of common stocks occur, in order to maintain the required ratio of total assets to the face value of outstanding bonds. Even in this latter case, full protection for the bondholder may require a most accurate forecast of the future trend of market values for portfolio securities by the individual charged with the duty of determining the value of the corporate assets.

Perhaps because of the foregoing considerations, the employment of bonds in the capital structures of open-end investment companies is comparatively rare. In the case of Affiiated Fund, Inc., one of the few such companies which have issued debentures, the complexities created have led at least one member of the company's management to question the advisability of bonds in the company's capital structure.[699]

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[697] Where, as in the case of Affiliated Fund, Inc., discussed infra (pp. 1872–3), the bondholders may on redemption prior to maturity of the bonds obtain only a sum less than the face value of their debentures, redemption of such debentures will actually increase the asset value of the common stock.

[698] See the discussion of the protective provisions of the bonds of Affiliated Fund, Inc., infra, pp. 1872–3.

[699] Public Examination, Affiliated Fund, Inc., at 18386.

(1) AFFILIATED FUND, INC.

Affiliated Fund, Inc., an open-end management investment company, was authorized by its charter to issue common stock and 10-year 5% convertible debentures.[700] At the end of 1936, there were $855,000 of debentures outstanding and the common stock equity totaled approximately $2,100,000.[701] The holders of the common stock had the privilege of tendering their stock at any time to the company, which undertook to repurchase it at the current asset value.[702]

With respect to the debentures, the company covenanted that it would at all times maintain assets up to at least 125% of all debentures and other funded obligations of the corporation outstanding and in the event of the failure of the company to do so the trustee was obliged to redeem by lot and retire such principal amount of debentures as might be necessary in order to fulfill the requirements of that provision.[703] The debentures might also be surrendered at the option of the holder at 95% of face amount during the first two years after issuance. Thereafter the redemption price increased by ½% each year until the date of the maturity of the debentures.[704]

George D. Cherry, Trust Officer of the First National Bank of Jersey City, New Jersey, the trustee under the indenture,[705] testified that the open-end provision in favor of the common stock was paramount and hence the company would have to repurchase the common stock tendered even though the consequent reduction of the company's assets would bring the asset coverage for the debentures below the "touch-off" point:[706]

Q. * * * suppose the assets amount to $125,000 and suppose your debentures amount to $100,000, which brings that right to the touch-off point, just over the line; let us assume that the market is stable and you do not have to consider any further market shrinkage, so as to make the thing more simple. Now, a stockholder comes in, we will say, with $1,000 worth of stock in the Fund, and either directly through you or through the corporation surrenders his $1,000 at its liquidating value for redemption. Would you mind describing just what would be involved and what action you would thereupon take?

A. We would take this action: After following the procedure required by the trust agreement for the redemption of this stock, we would at the significant time, which I am assuming is the time that you mentioned, we would complete that transaction. That would immediately put it below the 125% mark. Then we would immediately proceed in the usual course to sell, to bring it up above that mark, because our bank as trustee has always contemplated the various functions of this trust as a separate and distinct function, and the fact that one particular or phase of the set-up is, we may say, bordering on the border

[700] Affiliated Fund, Inc., was incorporated in May 1934 by Thomas F. Lee and several associates who had been previously affiliated with North American Trust Shares, a fixed trust. In October 1934 Lord, Abbett & Co., Inc., which had been engaged in the distribution of fixed trust shares, took over the sponsorship of Affiliated Fund, Inc. (Public Examination, Affiliated Fund, Inc., at 18272, 18275–6, and Commission's Exhibit No. 2046).

[701] Id., at 18273–5.

[702] Id., Commission's Exhibit No. 2046 (Paragraph "Fourth (4)").

[703] Id., Commission's Exhibit No. 2049.

[704] Ibid.

[705] Under the somewhat unusual indenture the trustee administered the redemption of the common stock as well as the incidents of the debentures (id., Commission's Exhibit No. 2049).

[706] Id., at 18339–40.

line which might cause us to do other duties, nevertheless that should not affect in any way the privilege which is accorded to other individuals in regard to their holdings. It comes down to a very practical operation under the circumstances as we view it.

Q. * * * In other words no matter what the status, what the actual status of the Fund is as far as assets are concerned, when a stockholder comes in and asks for his funds for redemption, he is bound to receive whatever liquidating value his share are worth irrespective of all other considerations?

A. That is the attitude we seek to maintain.

The witness testified that, upon being compelled to reduce its assets below the "touch-off" point, the company (or trustee) would proceed to sell portfolio securities, obtain cash and liquidate enough debentures to bring the coverage up to the required ratio.[707]

Q. * * * You would sell the securities first and then be forced to do something else?

A. We would call the debentures, the mechanics of which are set up in the instrument; but that is not the prime emergency; the prime emergency is obtaining the cash available to pay them and maintain the ratio. They may be called in later. Some of the people may be in California or in other States.

It was pointed out that under the given conditions the trustee would have to liquidate debentures of four times the value of the amount of common stock redeemed with the result that there would be an extremely rapid diminution of the fund.[708]

It may be noted that a precipitous decline in portfolio values when the 125% coverage has already been impaired by redemption of common stock may render it impossible for the company to redeem debentures at the full liquidating value.[709] While bound by a covenant to common stockholders the compliance with which might result in lowering the asset coverage for debenture holders below 125%, the company nevertheless categorically agreed to maintain the asset coverage at 125%. The paramount covenant to common stockholders may subject the company to the unavoidable necessity of violating, even if only transiently, its pledge to debenture holders to maintain the minimum asset coverage of 125%.

Andrew J. Lord, the president of Affiliated Fund, Inc., in a letter dated May 26, 1937, to one of the directors, expressed some uncertainty as to the continuing advantages of bonds in the capital structure of the company:[710]

It seems to me fundamental that unless we have a strong conviction that the trend of the stock market is upward for the next two or three years, we have no moral right to continue Affiliated Fund on its present set-up. We are borrowing money at a high rate of interest in the expectation of being able to use that money to advantage in the stock market. If this premise is wrong, then our whole basis of operation is wrong. But at this stage of our industrial recovery we will find few people who will argue against the position of the upward trend for a long time.

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[707] Id., at 18337–8.

[708] Id., at 18341–2.

[709] The same difficulty may arise when a substantial part of the assets of the company are not immediately liquidable.

[710] Op. cit. supra, note 700, at 18386–7.

In fact, I think you know it is my thought that at some time within the next two or three years we should voluntarily call all outstanding debentures, even though such action will result in a substantial loss of management fees.

VI. DEVICES OF CONTROL AND RELATED PROBLEMS

The control of large pools of public funds possessed by investment companies as heretofore discussed in this chapter was made possible to sponsors, managers, and other insiders through the device of a variety of multiple security capital structures. Furthermore, the control afforded through the ownership of one investment company by another in pyramided corporate systems or through cross or circular ownerships, is specifically treated in another chapter of this part of the report.[1] The devices of control considered in this section were employed by the sponsors of investment companies to secure control without the necessity for majority beneficial ownership of the principal voting security issues.[2] These devices of control either were vested in the management groups through the positions of control normally occupied by them or were created by the sponsors at the time of organization of the investment companies when these sponsors had absolute and uncontrolled discretion.

Of primary importance to the investor is his opportunity to supplant the management of his investment company when the conduct of those representatives no longer meets with his approval. The divorcement of control over management from the ownership of the investment company almost invariably presents vital problems. The problems are most acute where the insulation of management from ownership is complete—where the beneficial owners of the fund are deprived of any voice in the conduct of the management. The devices of control discussed in this section so limited and circumscribed or even entirely negated the voting privilege as to be ineffectual except in instances of flagrant misconduct on the part of the management group.

Nor is the contention, often advanced by controlling insiders who have made no investment or only a small investment in an investment company, that the investor may withdraw from an investment company by the sale or other disposition of his interest in the company if he is dissatisfied with the management, a justification for the separation of ownership from control. In closed-end investment companies, where the shareholder does not have the right to compel redemption of his shares at asset value, the investor must dispose of his securities in the open market, and when performance is indifferent these securities may be selling at substantial discounts from their asset values. In any case, the shareholders own the entire proprietary interests in these investment organizations, to participate in which they paid substantial sums including spreads or sales loads on the securities distributed. These investors are, therefore, entitled to have

[1] See Ch. VII of this part of the report which deals with management of assets.

[2] Managements and affiliated interests owned 50% or less of the voting stock of 106 out of 136 management investment companies proper and investment-holding companies at the end of 1935 (Pt. Two [House Doc. No. 70, 76th Cong.], Ch. V, Tables 119 and 120).

these companies honestly and competently managed as continuing enterprises and should not be compelled by such considerations to dispose of their investments at times which may be unpropitious. The power to dispose of one's interest in an investment company is not equivalent to the privilege of remaining an investor in an enterprise managed by individuals subject to the ultimate control of the beneficial owners.

A. Control Through Sponsorship

The control of an investment trust or investment company is exercised through a board of managers, known as trustees in the case of a trust and as the directors in the case of a corporation. While this section is concerned with some of the methods employed by sponsoring groups to appoint and maintain their representatives upon these boards of managers, there are certain advantages inherent in the offices themselves which tend to perpetuate the tenure of the incumbents. These advantages possessed by incumbent managers to maintain themselves in office constitute a constant factor in the control of all investment companies regardless of any other device also employed.[3]

1. "PRACTICAL" VOTING CONTROL

The sponsors of investment companies have invariably controlled the selection of the members of the initial boards of directors at the time of organization. These members have been selected for the boards prior to the distribution of the voting or other securities to the public. One method of assuring the maintenance of this control is for the management to continue to retain the ownership of majority voting control. In 1935 affiliated interests of about one-fifth of all management investment companies proper, with assets of $500,000 or more, beneficially owned the majority voting power of these companies.[4] This ownership, of course, does not imply that as much as half the capital of these investment companies was subscribed by these insiders. In fact, such majority voting control was usually limited to investment companies which restricted voting power to one of two or more classes of their outstanding securities.[5]

As a rule less than two-thirds of the outstanding voting shares have been represented, either in person or by proxy, at annual stockholders' meetings.[6] It is thus apparent that 30% stock ownership would constitute a degree of control which would ordinarily be invulnerable to attack by any outside group. In many cases, as little as 10% stock ownership constituted working or practical control. In 1935, affiliated interests in approximately 40% of the number of management investment companies proper beneficially owned at least 30% of the outstanding voting stock and in approximately 60% of management investment companies proper these interests owned at least 10% of the outstanding voting shares.[7] The voting power of the security

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[3] See discussion, Pt. Two (House Doc. No. 70, 76th Cong.), Ch. V, pp. 398–403.

[4] Id., pp. 409–12, and Table 121.

[5] Id., pp. 399–402. For a discussion of limited voting powers, see supra, pp. 1582–3.

[6] Op. cit. supra, note 3, pp. 399–402.

[7] Id., pp. 409–12, and Table 121.

holdings of affiliated interests was, therefore, a primary factor in the control of investment companies of the corporate type.[8]

2. CONTROL OF PROXY MACHINERY

The control over the proxy machinery of an investment company which is possessed by the board of directors, itself provides a formidable defense against threats to their continued tenure of office. This machinery consists of ready access to stockholders' lists[9] and to corporate funds for the solicitation of proxies.[10] Furthermore, the position of familiar authority occupied by the officers and directors of an investment company, as the ones who have managed its affairs in the past and who have published its condition in periodic statements, gives them a decided advantage over unknown outside shareholders who would have solicited proxies for what might prove an expensive and doubtful struggle.[11] An opposing group, even if it made out a strong case for a change of management, would be confronted with the task of overcoming the inertia of the usually apathetic stockholder in its effort to accumulate the required voting power. Such a showing to a small investor might well serve only to persuade him to liquidate his holdings and to invest the proceeds in some other organization. A factor which has emphasized this condition has been the increase in number of small stockholders,[12] a condition which has resulted from wide distribution, sometimes deliberately effected, and the tendency to larger investment companies.[13]

Another factor strengthening the entrenchment of the incumbent management is the cooperation afforded by affiliated banks and brokers in securing proxies from independent shareholders in the event of a proxy fight. Thomas E. Brittingham, discussing his experience when he sought to secure a change in the management of Fourth National Investors Corporation, testified:[14]

Q. What is your opinion as to how this board was able to perpetuate itself so well?

A. If you have ever had any experience in a proxy fight in an investment trust, it is rather enlightening. In the first place, the management in power distributes their brokerage rather effectively, so that when it comes to a stockholders' fight, brokers that have had favors in the past are expected, and do, get out and solicit proxies. That puts the stockholders' committee at quite a

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[8] For an illustration of "practical" voting control, see Standard Investing Corporation, infra, p. 1883. Sponsors frequently obtained such voting stock in exchange for unmarketable property and securities or for property and securities at inflated prices, (See Ch. VII of this part of the report which deals with management of assets) and sometimes for distribution and management services. (See also the discussion of Italian Superpower Corporation, supra, pp. 1621–3.)

[9] The right to inspect stockholders' lists is usually preserved by statute, e. g., General Corporation Law of Delaware (Revised Code of 1935, as amended), Art. 1, Sec. 29.

[10] *Hall* v. *Trans-Lux Daylight Picture Screen Corp. et al.*, 20 Del., Ch. 78, 171, A. 226 (1934).

[11] See Ch. IV of this part of the report, pp. 1017 et seq.

[12] For a statistical analysis of the predominance of small stockholders, see Pt. Two (House Doc. No. 70, 76th Cong.), Ch. V, pp. 379–88.

[13] See Pt. One (House Doc. No. 707, 75th Cong.), Ch. III, pp. 57–62. Investment companies having assets in excess of $10,000,000 possessed well over 70% of the aggregate resources invested in that industry at the end of 1935 (Pt. Two, Ch. II, Table 23).

[14] Public Examination, National Investors Corporation, at 4480–1.

disadvantage, because it gives the brokers with offices all over the country personal contact that is rather hard to beat.

Q. Do you think that that situation was enhanced by the fact that National itself had originally been privately created through banks in order that they might assist in the distribution of the subsequent trusts?

A. That had a tremendous amount to do with it, particularly in Detroit. The bankers there, with the exception of Detroit Trust Company, used their influence to get their customers and trust accounts that were left with them to favor the management, and while it is true that several of those banks, I guess most of them, have been reorganized, still through personal contact and other means the interest is there, so it is sort of a repercussion of having given a lot of warrants out to the bankers. It was hard in talking with the stockholders—[They] would say, "Well, I am going down to see my friend Banker so and so." The banker, having an interest in National Investors, naturally told him where to give his proxy.

Q. You really ran across those cases?

A. Quite a few of them; yes.

Q. You were not able to overcome the advice the banker gave?

A. No, sir. I spent several days out in Detroit in two different years, and the results are practically negligible.

This study has disclosed that, in almost every case where the original sponsors placed their representatives in positions of control over investment companies, this control, except where voluntarily surrendered, has continued and is still exercised.[15] In many instances where transfers of control have been effected some special consideration has been accorded to the retiring management, in the form of a premium payment for the sponsors' holdings or by way of some special bonus, commission, or business patronage.[16] That special treatment of this kind has been considered necessary, even when the management has not possessed voting control,[17] is itself evidence of the importance of control over the proxy machinery.

a. Transfers of Control of Boards of Directors Through Seriatim Resignations and Elections of Directors

The corporation laws of the various states usually permit the boards of directors of corporations to fill vacancies in their memberships between annual meetings.[18] This power not only has provided the management groups with the means of perpetuating their control, by the process of filling vacancies with their own nominees who then possess the advantages of other incumbents at annual elections, but has also afforded a device for substituting new groups into control merely at the approval of the old directors.[19]

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[15] See Ch. IV of this part of the report, pp. 1017 et seq.

[16] Ibid.

[17] For example, see the discussion of Sterling Securities Corporation, supra, pp. 1624–31.

[18] This power is specifically accorded by the General Corporation Laws of Delaware (Revised Code of 1935), Ch. 65, Art. 1, sec. 30, and may be written into the by-laws under the Stock Corporation Laws of New York (sec. 55, as amended by L. 1929, ch. 600; sec. 5, and L. 1930, ch. 239) and under the annotated Code of Maryland (art. 23, secs. 12, 15).

[19] Of 159 investment companies studied, 81 recited this power in the charters or by-laws; 72 others distributed the power variously between the stockholders and the directors, while the remaining six relied upon the statutory provisions of their states of incorporation.

The managers of investment companies, desiring to transfer control and purporting to act under this type of provision, have indulged in the practice of seriatim resignations of members of the old board and elections of new members to fill such vacancies by the remaining members of the board.[20] Thus, an old member of the board would resign and a new member would be elected by the remaining members of the board, then immediately another old member of the board would resign and another new member be elected, until a new majority of directors or an entire new board was elected. By this method, not only was an immediate passage of control effected without the necessity of waiting for the annual meeting or calling a special meeting of stockholders, but the other security holders were kept in ignorance of the change in control effected.[21]

The use of the scheme of seriatim resignations and elections of directors, particularly when arranged by insiders who do not own the requisite amount of voting shares necessary to effect a change in management at an annual or special meeting, raises the question whether this plan is not a flagrant circumvention of the basic right of the stockholders to select their directors. It may also be questioned whether this provision relating to the filling of vacancies is not merely applicable to vacancies created by conditions not subject to the control of the dominant personalities such as illness, death, and uncontrolled sporadic resignations, and not to controlled resignations effected with the preconceived intent to transfer the entire or a majority of the directorships to a new group.[22]

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[20] Formerly, no obligation rested upon the controlling stockholder to reveal to the minority stockholders his intent to, or the fact of, a transfer of his control to others. By Section 16(a) of the Securities Exchange Act of 1934, the beneficial owners of 10% or more of the equity securities of corporations which are registered on national securities exchanges are required to report any changes in the ownership of their holdings of such equity securities to the Commission and to the exchange on which the securities are listed within 10 days after the close of the calendar month in which such change in ownership occurs. These changes in ownership are published monthly by the Commission. However, Section 16(a) of the Securities Exchange Act does not require the revelation of the price paid for the transfer of any of these listed equity securities, a fact which is clearly of importance to other stockholders who thereafter may be solicited by the purchaser of the controlling block of securities to exchange or sell their shares to him at a price less than that paid for the controlling block of shares. Furthermore, the provisions of Section 16(a) of the Act do not apply to the transfer of beneficial ownership of securities which are not listed on national securities exchanges. The great majority of existing investment companies do not have securities listed on national securities exchanges. (See Pt. Two [House Doc. No. 70, 76th Cong.], Ch. IV. Table 86.) Finally Section 16 (a) does not apply to a transfer of control which is based not on stock ownership but on other devices, such as management contracts.

[21] This method of substituting directors by infiltration for the purposes of transferring control was employed by Wallace Groves in the acquisition of Interstate Equities Corporation, Chain & General Equities, Inc., Yosemite Holding Corporation, and Granger Trading Corporation (see Ch. II of this part of the report, pp. 181–227); by the Northern Fiscal Group in the acquisition of Burco, Inc., Insuranshares Corporation of Delaware, and Bond and Share Trading Corporation (see Ch. II, pp. 437–496); by the Fiscal Management Group in the acquisition of Continental Securities Corporation, First Income Trading Corporation, and Reynolds Investing Company, Inc. (see Ch. II, pp. 354–437); by Ernest B. Warriner in the acquisition of General Investment Corporation (see Ch. II, pp. 584–623); by the Thomas Watson Group in the acquisition of Oils & Industries, Inc. (see Ch. II, pp. 94–115); by Messrs. Cohen and Barnes in the acquisition of North and South American Corporation and Insuranshares Corporation of Delaware (see Ch. IV of this part of the report, pp. 1179–92); by David Milton in the acquisition of Atlantic and Pacific International Corporation (see Ch. IV, pp. 1120–37); and by Floyd B. Odlum in the acquisition of National Securities Investment Company (see Ch. IV, pp. 1094–1119).

[22] A controlling stockholder may transfer his shares to others at will, and even against the wishes of the minority stockholders, so long as the transfer is not part of a scheme to

This procedure was adopted by Carroll E. Gray, Jr., president of Burr & Company, Inc., in transferring control of Burco, Inc., an investment company operating as a trading corporation.[23] Without notice to the other security holders, including the preferred stockholders whose shares were partly under water,[24] this sponsor sold his and his associates' holdings, amounting to 40% of the common stock outstanding, at $9 a share under a contract dated February 28, 1938,[25] although the peak market price therefor in the last quarter of 1937 was never over $1.50 a share.[26] Mr. Gray, when examined as to the substitution of members of the purchasing group for the old members of the board of directors, testified:[27]

Q. Now, a new Board of Directors could not be—the old Board could not be put out by the stockholders and a new Board put on except in an annual meeting; is not that so?

A. Unless directors resigned.

Q. Unless directors resigned and that "unless directors resigned," Mr. Gray, was to cover the contingency if a vacancy occurred through sickness or resignation, etc.; is not that so?

A. Or unless they did not wish in their own disposition to resign.

Q. And do you honestly assert that it was really intended to cover a situation that the directors were going to bodily pass over control to somebody else, and just took the form of one resigning, electing a new one, and another one resigning, electing a new one, a third one resigning, and electing a new one?

A. I think that is a general practice.

Q. That is a general practice and that is what you thought it meant, articles of incorporation or bylaws meant when they said if there is a vacancy the Board can fill the vacancy; is that right?

A. I was guided by my attorneys in that action, as I was when I bought the stock originally.

This substitution of directors occurred but a few months after the stockholders had, at an annual meeting, voted the continuation of the old management in control over the affairs of the investment company for another year.[28]

Similarly, in the case of Continental Securities Corporation, control of the board of directors was transferred by the device of seriatim resignations. Allen W. Dulles, counsel for J. Henry Schroder Banking Corporation, the interests who transferred control, testified:[29]

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defraud minority stockholders. (See 13 Fletcher, Cyclopedia of Corporations, § 5805; Cf. *Barnes* v. *Brown*, 80 N. Y. 527 [1880].) However, contracts by which directors or minority stockholders, and possibly even majority stockholders (*Fennessy* v. *Ross*, 5 App. Div. 342, 39 N. Y. Supp. 323 [1st Dept. 1896]), expressly agree as an incident to the sale of their shares or otherwise, to transfer the offices and directorships of a corporation to others, that is, to "barter away" the offices of the companies and representations on their boards of directors are illegal as against public policy (*Fennessy* v. *Ross*, 90 Hun. 298, 35 N. Y. Supp. 868 [Gen. T. 1st Dept. 1895]; cf. *McClure* v. *Law*, 161 N. Y. 78, 55 N. E. 388 [1899]).

[23] Public Examination, Paine, Webber & Co. et al., at 884, 888.

[24] Id., at 876, 879.

[25] Id., at 859–60, 869, and Commission's Exhibit No. 91.

[26] Id., at 865. 30,000 of these 36,000 shares cost the sponsors originally $4 a share (id., at 890).

[27] Op. cit. supra, note 23, at 886–7.

[28] Id., at 886.

[29] Public Examination, First Income Trading Corporation, at 1657–61.

Q. Were you the one that suggested the mechanics that one director resign and another be elected, that another director resign and a new director be elected, and so on? Who suggested that scheme?

A. That is a very normal procedure at a closing. I suppose I have done that myself in connection with the changes of management companies a dozen times. That is the usual machinery.

Q. That is the usual machinery for that?

A. Correct.

Q. By usual you do not mean justifiable, do you, or sanctionable, do you?

A. Certainly. Yes. If you change managements that is the way, because you have to keep a quorum. The only way to retain your quorum is to have one resign at a time as new directors come in.

Q. I understand that, but as I understand the articles of incorporation of Continental Securities Corporation, the power to elect a new board of directors was vested in the stockholders, wasn't it?

A. Well, they could, but the new directors also could be elected by the board itself.

Q. Yes; but those provisions in the articles of incorporation or the bylaws which say that a board of directors can fill a vacancy, did you conceive that that was intended to mean that you could avail yourselves of that provision and completely turn out the old board and put in a new board?

A. That has been done a great many times.

Q. I understand that. You knew that this device of one resigning and another being elected ultimately resulted in the complete wiping out of the old board and the complete new board coming in?

A. That is right.

Q. And you also knew that in a normal situation where you elected a new board of directors it was to have the stockholders do that, wasn't that so?

A. I should say that both situations were quite usual.

Q. By "quite usual" you say both were done. Let me ask you: If it was a question of electing a new board of directors do you dispute that that was the inalienable right of the stockholders to select their entire new board to manage their funds?

A. They had the right to do it. They did not have the exclusive right.

Q. They could do it if the controlling interests did not indulge in some device which would deprive them of that right to do that; isn't that so? They could do it, as I understand it, if the controlling interests would let them do it; but, as I understand it, it was intentionally and deliberately done in order not to submit it to the stockholders—when one resigned and another was elected, and then another member resigned and someone was elected in his place, and so on?

A. The majority could, however, have elected the new board in a few weeks under the regular procedure, under the Maryland law.

Q. Or it could be done at the regular annual meeting?

A. With notice, yes.

Q. But if a special meeting was called it was necessary to put in the notice that the purpose was to clean out the old board and put in a new board?

A. That is so.

Q. And although that might have been managed from the point of view of voting power, because the controlling block was in the hands of the people who were selling the interest, you could not anticipate what legal steps the stockholders would take under the circumstances to possibly protect their interests; isn't that so?

A. Correct.

Q. So that this device of, shall we say "ring-around-the-rosy"—one going off and another going on, one going off and another going on, another going off and another going on, had as an ultimate end, did it not, to substitute a complete new board of directors?

A. That was the case.

Q. It was not a case where one fellow became sick and could not fulfill his duties as a director, an exigency existed, a vacancy was created and where somebody had to be substituted, was it?

A. No.

Q. They were all in perfectly good health?

A. Perfectly good health.

Q. And all compos mentis, too?

A. All compos mentis.

b. Perpetuation of Control Through Stagger System of Electing Directors

Another variation in the procedure of electing directors is to segregate them into groups or classes with only one group or class to stand for election at an annual meeting.[30] Obviously, by this method threats to control may be discouraged by reason of the fact that more than one special or annual meeting may be required to effect a change in a majority of the board.[31]

This system of electing directors prevailed in Oils & Industries, Inc., an investment company organized under the laws of the State of Maryland on February 19, 1928, under the name of Oil Shares Incorporated. Article II of the bylaws of this company, as effective on December 31, 1935, provided in part as follows: [32]

> SECTION 1. The Board of Directors of the Corporation is hereby divided into five classes. Each class shall consist of one-fifth of the entire membership of the Board as nearly as may be. In case the number of directors is increased or decreased by action of the Board, the Board shall re-classify the members thereof among the five classes herein provided for, but by affecting the tenure of office of each director as little as may be. It is the intent that at all times the Board of Directors shall be divided into five classes, each class having the

[30] Annotated Code of Maryland, 1924, Art. 23, sec. 14, provided:

> Every corporation may, by its bylaws, divide its directors into classes and prescribe the tenure of office of the several classes; but no class shall be elected for a period shorter than that from the time of the election following the division into classes until the next annual meeting and thereafter for a period shorter than the interval between annual meetings or for a longer period than five years, and the term of office of at least one class shall expire each year.

[31] A similar problem was presented in the stagger system of the election of members of the Board of Governors of the New York Stock Exchange. The Commission, in its Report on the Government of Securities Exchanges (House Doc. No. 85, 74th Cong., 1st Session), discussing this method of election, stated:

> The fact that only one-quarter of the governors are elected in any one year seems also to contribute to the perpetuation of control and to make changes of policy difficult to effectuate in any reasonable period. The requirements of other exchanges generally call for the election of one-third of the governors each year. Continuity of policy through experienced governers is, of course, to be desired, but the annual turnover in the governing committee should not be so small as to prevent the ready response of the government of the exchange to new desires and fresh aims.

[32] Reply to the Commission's questionnaire for Oils & Industries, Inc., Pt. I. These bylaws also provided that a majority of the remaining board of directors could fill vacancies in its membership (including vacancies through an increase in size) although they constituted less than a quorum (ibid.).

same number as nearly as possible. The tenure of office of each director elected by the stockholders after the first annual meeting shall be for five years and until his successor is duly elected and qualified. At each annual or general election directors shall be elected only to fill the vacancies caused by the expiration of the terms of office of the directors whose terms have expired or are about to expire. It is the intent that continuity in management may thus be had by electing only one-fifth of the Board each year. Of the fifteen persons named as directors in the amended Certificate of Incorporation of the Corporation, the first three named shall have tenure of office expiring in five years, the next three in four years, the next three in three years, the next three in two years and the last three in one year.

Thus it will be observed that the directors held office for a term of five years and the same management was assured of continued control for at least three years.

A similar provision was contained in the bylaws of Tri-Continental Corporation [33] and the board of directors could decrease or increase the size of its membership and fill the vacancies thereby provided.[34]

Earl Bailie admitted that this stagger system of electing directors was a means of perpetuating the control of the sponsors, when he testified: [35]

Q. The staggering of directors prevented a sudden change, is that right?

A. Exactly.

Q. By a new person acquiring the stock of Tri-Continental and kicking out all the directors?

A. The purpose of that transaction was to make it unattractive to the person acquiring it.

The Commission adopted and published revised proxy rules, effective October 1, 1938.[36] These rules apply only to securities registered on national securities exchanges [37] and provide primarily for a full disclosure of the matters to be voted upon, in the form of a proxy statement. An important requirement of the rules is that the security holder who is being solicited must be given the opportunity to direct how his vote shall be cast upon each of the items under consideration.[38]

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[33] Reply to the Commission's questionnaire for Tri-Continental Corporation, Pt. I.

[34] Ibid.

[35] Public Examination, Tri-Continental Corporation, at 18646–7.

[36] Proxy rules designated as Regulation X14 were adopted by the Securities and Exchange Commission pursuant to authority conferred upon it by the Securities Exchange Act of 1934, particularly Secs. 14 (a) and 23 (a) thereof. These rules were extensively amended as of February 15, 1940.

[37] Of 491 investment companies at the end of 1936, 82 had a total of 130 security issues listed on the various security exchanges (Pt. Two [House Doc. No. 70, 76th Cong.], Ch. IV, Tables 84 and 87).

[38] Schedule 14A of the rules, consisting of information to be contained in proxy statements, provides in part for the publication of the offices to be filled at the meeting and the persons nominated therefor; the remuneration paid, directly and indirectly, to the three principal persons so nominated, during the preceding year; the interests of such persons in property acquired (in two years) or proposed to be acquired by the corporation, the cost thereof and the date of acquisition by such persons; the holdings of such persons in the corporation, both of record and beneficial; the affiliations of such persons for the past five years with the principal underwriter of the securities of the corporation; and like information concerning the persons primarily responsible for the original nomination of such persons.

(1) STANDARD INVESTING CORPORATION

Standard Investing Corporation illustrates both the substantial control afforded by the ownership of a block constituting something less than half of the outstanding voting stock, as well as the voting power provided by control over the proxy machinery.[39] This investment company was organized on January 31, 1927, under the sponsorship of Brown Brothers & Company and Stone & Webster and Blodget, Inc., investment bankers.[40] The total net contributed capital of the investment company [41] was $14,553,874 which was received from the sale of two 10-year debenture issues and two issues of preferred stock, while the common stock was issued under warrants, by conversion of senior issues, as a bonus with preferred stock, and as a gift to Brown Brothers & Company.[42]

Although the common and preferred stocks each possessed one vote a share,[43] the voting power was essentially in the common stock. Brown Brothers & Company received 25,000 common shares at the time of the original distribution as a promotion fee, while a maximum of 15,000 additional common shares and 15,000 preferred shares were outstanding and entitled to vote.[44] The remaining 45,000 shares issued were deposited with a trustee for the benefit of debenture holders under warrants exercisable after March 1, 1930.[45] Accordingly, in the beginning, this sponsor held substantial voting control without any investment.

Standard Investing Corporation was managed from 1927 through 1936 by Brown Brothers & Company and its successor, Brown Brothers Harriman & Company. This control was effected by a board of directors consisting entirely of members of that firm with the exception of one representative of Stone & Webster and Blodget, Inc., and a member of the law firm of Sullivan & Cromwell. With the increase of outstanding common stock to 394,591 shares by December 31, 1935, this control came to depend almost entirely upon the proxy machinery.[46] The leverage structure afforded by increased debenture issues, accounting for a total of $9,120,000 of the paid-in assets,[47] accentuated the vulnerability of the management control upon the declining markets following the market crash of 1929, by reason of the decreasing capital represented by the voting shares. Nevertheless, the directors selected by Brown Brothers Harriman & Company were elected annually, without opposition,[48] until 1936 when Phoenix Securities Corporation, an investment company operated by Wallace Groves, appeared as the owner of 120,000 common shares, equivalent

[39] See Pt. Two, Ch. V, pp. 399–402.

[40] Reply to the Commission's questionnaire for Standard Investing Corporation, Pt. I.

[41] During the period ending December 31, 1935, the investment company repurchased debentures and preferred shares at a cost of $3,891,139, representing a capital gain to the company (or loss to retiring investors) of $1,546,061, and at that date the net assets of the investment company had a market value of approximately $8,840,000 (Public Examination, General Investment Corporation, Commission's Exhibit No. 1578).

[42] Public Examination, General Investment Corporation, Commission's Exhibit No. 1578.

[43] Op. cit. supra, note 40, Pt. I (Exhibits 3, a, b).

[44] Op. cit. supra, note 42, at 15241, and Commission's Exhibit No. 1578.

[45] Id., Commission's Exhibit No. 1578.

[46] Ibid.

[47] Ibid.

[48] Id., at 15242.

to about 30% of the total common shares outstanding, and demanded control of the investment company.[49] Brown Brothers Harriman & Company refused to turn over control.[50]

Both factions then engaged in a campaign to secure the proxies of stockholders to be voted at the next annual meeting to be held in March 1936.[51] In spite of the relatively small holdings of the management group, consisting of the aforementioned 25,000 common shares plus some 3,000 or 4,000 additional shares owned by the families of individual partners,[52] stockholders gave sufficient proxies to the old and familiar management to provide them with a plurality of about 40,000 votes.[53]

Phoenix Securities Corporation constantly increased its holdings until it controlled 163,000 shares,[54] an increase of more than the plurality in voting strength enjoyed by the management group at the last annual meeting. At the end of 1936, less than a year after Brown Brothers Harriman & Company had asked stockholders to sustain its management, that firm acceded to the sale by Phoenix Securities Corporation of control of Standard Investing Corporation to General Investment Corporation.[55]

(2) AMERICAN INTERNATIONAL CORPORATION

American International Corporation is illustrative of an investment company which experienced shifts in management practices by reason of changes in the personnel of the board of directors. This company was organized on November 23, 1915, under the laws of the State of New York [56] by Frank A. Vanderlip, president of The National City Bank of New York, to supplement the foreign financing already conducted by that bank.[57] Stockholders of The National City Bank of New York were given an opportunity to subscribe to the stock of the company in proportion to their holdings in the bank,[58] and the remainder of the $49,000,000 common stock and $1,000,000 preferred stock comprising the original offering was subscribed to by Mr. Vanderlip and his associates.[59] The original management was as follows: [60]

Frank A. Vanderlip was the chairman of the board and Charles A. Stone was president. The directors included J. Ogden Armour, of Armour & Company; Charles A. Coffin, of General Electric Company; William E. Carey, of Midvale Steel & Ordnance Company; Robert Dollar, of Robert Dollar Company; Joseph P. Grace, of W. R. Grace & Company; Pierre S. du Pont, of E. I. du Pont de Nemours & Com-

[49] Id., at 15246–7.

[50] Id., at 15248.

[51] Id., at 15242.

[52] Id., at 15241.

[53] Id., at 15249, 15261.

[54] Id., at 15249, 15270–2.

[55] Id., at 15253–5. For details of sale of control of Standard Investing Corporation to General Investment Corporation see Ch. II of this part of the report, pp. 613–17.

[56] Public Examination, American International Corporation, at 6688, and Commission's Exhibit No. 614.

[57] Id., Commission's Exhibit No. 616.

[58] Ibid.

[59] Id., at 6692.

[60] Id., at 6694–5, and Commission's Exhibits Nos. 616 and 617.

pany; Robert F. Herrick, a Boston lawyer; Otto H. Kahn, of Kuhn, Loeb & Company; Robert S. Lovett, of Union Pacific Railroad Company; Ambrose Monell, of International Nickel Company; Henry S. Pritchett, of Carnegie Foundation; Percy A. Rockefeller; John D. Ryan, of Anaconda Copper Company; William L. Saunders, of Ingersoll-Rand Company; James A. Stillman, of The National City Bank of New York; Charles A. Stone, of Stone & Webster; Guy E. Tripp, of Westinghouse Electric & Mfg. Company; Theodore N. Vail, of American Telephone & Telegraph Company; Frank A. Vanderlip, of The National City Bank of New York; Edwin S. Webster, of Stone & Webster; Albert H. Wiggin, of Chase National Bank; Beekman Winthrop, of Robert Winthrop & Company; and William Woodward, of Hanover National Bank.

American International Corporation operated as an organization for foreign investments under the domination of Mr. Vanderlip and Mr. Stone until 1923.[61] These operations ultimately proved so unprofitable that Mr. Vanderlip and Mr. Stone[62] withdrew from their respective offices and Mathew C. Brush, a director and senior vice president, was elected president.[63] Thereafter American International Corporation evolved into a diversified investment company.[64] Mr. Brush remained president until November 1933, when he became chairman of the board and Harry A. Arthur, who had been with the company and its subsidiaries almost from the very beginning, was elevated from the vice presidency to the presidency.[65]

During this entire period there were frequent shifts in the personnel of the board of directors of American International Corporation, resulting in a constant ebb and flow of the influence of the affiliated groups. While some of these groups were backed by substantial stock ownership, their control was apparently effected primarily by the personal influence of a few directors who represented them upon the board.

Thus, Blair & Co., Inc., secured three directorships upon the board of American International Corporation in April 1925, one of whom retired April 6, 1927, and the other two remained until January 12, 1928.[66] These directorships were accorded to Blair & Co., Inc., by reason of its trading operations in the shares of American International Corporation during the years 1924–27, which resulted in the acquisition of 36,667 shares (out of 490,000 shares outstanding)[67] by that banking house on July 15, 1926.[68] These holdings were liquidated at a profit during 1927.[69]

Similarly, Scott & Stringfellow, investment bankers and brokers of Richmond, Virginia, acquired some 10,000 shares of the common stock

[61] Id., at 6698–6703 and 6712.

[62] Mr. Stone remained as a director, retiring in 1928 (id., Commission's Exhibit No. 617).

[63] Op. cit. supra, note 56, at 6707, 6714, and Commission's Exhibit No. 617.

[64] Id., at 6814–15.

[65] Id., at 6687, 6691. In January 1935 Mr. Brush resigned as chairman of the board but remained a director.

[66] Op. cit. supra, note 56, at 6741. These directors, in the order of their retirement, were Edward R. Tinker, Harry Brawner, and Elisha Walker (ibid.).

[67] Id., Commission's Exhibit No. 617.

[68] Id., Commission's Exhibit No. 621.

[69] Ibid. Blair & Co., Inc., realized total profits of $1,423,597.57 from such operations during the 1924–1927 period (ibid.).

of American International Corporation in the early part of 1927, and on April 5, 1937, two members of that firm were elected to the board of directors.[70] These directorships were retained until 1936, although their total voting power never exceeded 30,000 shares out of 1,019,757 shares outstanding at the end of 1929, and were substantially scaled down thereafter.[71]

Also in April 1927, the brokerage and banking house of Lazard Frères secured representation upon the board of directors of American International Corporation, presumably by virtue of the ownership by that firm of 10,000 shares of the capital stock of the investment company.[72] The voting strength of Lazard Frères reached a peak at September 30, 1928, of 38,588 shares out of 490,000 shares outstanding, and by the end of 1930 the holdings had been substantially liquidated.[73] Nevertheless, this representation was retained until 1935.[74]

In December 1928 Arthur Lehman, of Lehman Brothers, investment bankers and brokers, was elected to the board of directors of American International Corporation,[75] at which time the stockholdings of that firm in the investment company reached a total of 12,540 shares out of 490,000 shares outstanding.[76] This investment was substantially reduced at the end of 1929 and completely sold out at the end of 1930.[77] Nevertheless, Mr. Lehman remained upon the board until his death in 1936.[78]

Thereafter, three investment companies became interested in the shares of American International Corporation. Solvay American Investment Corporation (changed to Solvay American Corporation on May 15, 1937) began to acquire shares of American International Corporation in 1929 and its holdings increased from 19,135 shares at March 31, 1930 to 105,000 shares on March 31, 1937.[79] Requesting representation by virtue of these holdings, Solvay American Investment Corporation was allotted one directorship in 1929 and two more by 1936.[80] Similarly, Sterling Securities Corporation held 18,800 shares of American International Corporation in its portfolio at the end of 1931, which increased to 22,000 shares at the end of 1935.[81] Although at October 31, 1937, after the merger of Sterling Securities Corporation with Atlas Corporation, no such holdings appeared in

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[70] Op. cit. supra, note 56, Commission's Exhibit No. 625. The directors were Buford Scott and Frederic W. Scott (id., Commission's Exhibit No. 617).

[71] Id., Commission's Exhibit No. 625, and reply to Commission's questionnaire for American International Corporation, Pt. II. Such sales were generally made at a loss (ibid.).

[72] Op. cit. supra, note 56, Commission's Exhibit No. 624. This director was Frank Altschul (id., Commission's Exhibits Nos. 617 and 626).

[73] Id., Commission's Exhibit No. 624. Lazard Frères realized total net profits of $3,125,628.28 from these investments (ibid.).

[74] Id., Commission's Exhibit No. 617.

[75] Id., at 6802.

[76] Id., Commission's Exhibit No. 626.

[77] During the period 1927–1932 the holdings of American International Corporation common stock by General American Investors Co., Inc. (and its predecessors), sponsored by Lehman Brothers and Lazard Freres, never exceeded 6,000 shares (Reply to the Commission's questionnaire for General American Investors Co., Inc., Pt. III).

[78] Op. cit. supra, note 56, Commission's Exhibits Nos. 617 and 626.

[79] Derived from supplementary information supplied the Commission for Solvay American Investment Corporation, and *Poor's Fiscal Volume,* 1938.

[80] Op. cit. supra, note 56, Commission's Exhibits Nos. 617 and 627. Felix E. Notebaert became a director in 1929 and Clinton Lutkins and Donald Duncan were added by 1936 (ibid.).

[81] Reply to the Commission's questionnaire for Sterling Securities Corporation, Pt. III.

the consolidated portfolio, Hugh R. Johnston, who was elected to the board of American International Corporation in 1936 while president of Sterling Securities Corporation, was still a director of American International Corporation at December 31, 1937.[82]

The third investment company to appear as a substantial stockholder of American International Corporation was The Adams Express Company, whose holdings increased steadily from 31,300 shares at the end of 1932 to 256.800 shares on December 31, 1937.[83] These holdings inspired the election of two members of Hayden Stone & Co., which firm dominated the management of The Adams Express Company,[84] as directors of American International Corporation in November 1933.[85]

The influence exerted by these various management groups may be appraised by their direct and indirect dealings with the investment company. Brokerage was paid to connected interests in only small amounts until April 1927, when Lazard Frères obtained representation upon the board of directors. From 1927 to 1934, inclusive, that firm received $427,704 of brokerage commissions.[86] Next brokerage firm to obtain representation upon the board of directors, in December 1928, was Lehman Brothers, which received $72,565 of brokerage commissions from 1929 to 1935, inclusive.[87] Finally, Hayden Stone & Co., which was first represented upon the board of directors in November 1933, received an aggregate of $63,360 of brokerage commissions to December 31, 1935.[88]

On January 18, 1929, Lazard Frères and Lehman Brothers underwrote an issue by American International Corporation of $25,000,000, 25-year, 5½% debentures, due January 1, 1949.[89] The underwriting commission upon this offering was $1,000,000.[90] In 1932, Lazard Freres resold $370,000 of these debentures to American International Corporation two or three points above the market.[91]

Six of the seven major investments made by American International Corporation at a cost of $10,257,652.25, were substantially extant in its portfolio at December 31, 1935, at which date they had depreciated approximately 60 percent.[92] An investment of $2,604,842.97 in the securities of The Chase National Bank of the City of New York was admittedly influenced by Albert Wiggin, while the largest single investment, of $2,710,357.36 in the shares of The Texas and Pacific Railway Company, was made at the suggestion of Lazard Freres and Mathew C. Brush. Similarly, an investment of $539,156.48 in the shares of Purity Bakeries Corporation was recommended by

[82] *Poor's Fiscal Volume,* 1937 and 1938. Hugh R. Johnston was not listed among the officers and directors of the consolidated Atlas Corporation (ibid.).

[83] Reply to the Commission's questionnaire for The Adams Express Company, Pt. III, and *Poor's Fiscal Volume,* 1938.

[84] See infra, pp. 1891–4.

[85] Op. cit. supra, note 56, at 6809, and Commission's Exhibit No. 617. These directors were Charles Hayden and Steele Mitchell (ibid.).

[86] Id., Commission's Exhibit No. 623.

[87] Ibid.

[88] Ibid.

[89] Reply to the Commission's questionnaire for American International Corporation, Pt. I.

[90] Op. cit. supra, note 56, at 6804–5. Prior to this offering the $1,000,000 of preferred stock outstanding was retired (id., at 6809).

[91] Id., at 6807.

[92] Op. cit. supra, note 89, Pt. III.

Lazard Frères while $986,113.13 was invested in the shares of The Lehman Corporation, an investment company sponsored by Lehman Brothers.[93]

Five direct portfolio transactions, involving a total of $607,875, were negotiated by American International Corporation with Lehman Brothers, one also participated in by Lazard Frères,[94] from 1929 to 1935, inclusive.[95] The largest single transaction of this kind, involving the sale of 2,000 shares of common stock of W. T. Grant Company to American International Corporation for $264,000, was effected at a price in excess of the bid market price and resulted in a loss to the investment company.[96] Lehman Brothers was connected with W. T. Grant Company, as well as with two other companies whose shares were involved in such transactions, as underwriter and by director representation. Hayden Stone & Co. did not engage in such direct sales to the investment company as a matter of policy.[97]

B. Control Through Type or Form of Organization

The sponsors or organizers of investment trusts or investment companies completely controlled the form and details of organization. As a consequence, the organic form of some investment companies was in no small measure dictated by a desire to control large pools of funds without the necessity for any substantial investment by the managers. One method of securing this control was to adopt an organic form, such as the Massachusetts or business trust or the New York joint stock company, in which the voting powers of shareholders could be restricted or eliminated.

1. MASSACHUSETTS TRUSTS

The Massachusetts or business trust was often employed instead of the corporate form of organization in the Boston area. It is characteristic of this device that complete control is vested in the trustees, who usually are self-perpetuating, without the necessity of investing any personal funds in the enterprise. Of 152 management investment companies proper in existence at the end of 1936, 20 were of the Massachusetts trust type of which 12 were closed-end and 8 open-end companies.[98] Such Massachusetts trusts held about 17% of the assets of the management investment companies proper included in the group at the end of 1927 but only 5% to 6% from 1929 to 1932, thereafter rapidly increasing to 12% at the end of 1936. The increase in their assets reflects chiefly the increase in the assets of

[93] Ibid., and derived from supplementary information supplied the Commission for American International Corporation.

[94] Half of the W. T. Grant Company stock sold was provided by Lazard Frères (op. cit. supra, note 56, at 6804–5).

[95] Op. cit. supra, note 89, Pt. VII.

[96] Ibid.

[97] Op. cit. supra, note 56, at 6807–8.

[98] For the detailed break-down for the years 1927–1936 of investment companies proper by form of organization, see Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II, Table 26; see also Ch. III of this part of the report, p. 803.

Massachusetts Investors Trust as the combined result of sales of its securities and some market appreciation of its portfolio.[99]

Business trusts have been known to business and commerce in England for many years.[100] Similarly, it has been the practice in Massachusetts for a number of years[101] for persons to combine their capital in business trusts for the purpose of conducting almost any kind of business with limited personal liability and at the same time to avoid the use of the corporate form of organization. Due to their early American origin in Massachusetts they have come to be referred to in this country as "Massachusetts Trusts." In recent years, however, business trusts have been created and operated in a number of states and their validity is now extensively recognized.[102] Business trusts are still largely the creatures of common law although in some states they have formed the subject of specific statutory enactment.[103]

The Supreme Court of the United States defined the business trust as:[104]

a form of business organization * * * consisting essentially of an arrangement whereby property is conveyed to trustees, in accordance with the terms

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[99] Pt. Two (House Doc. No. 70, 76th Cong.), Ch. II, pp. 59–60. Massachusetts Investors Trust is the largest investment trust of the open-end type, with net worth of $128,107,000 at the end of 1936 (derived from supplementary information supplied the Commission for Massachusetts Investors Trust). The beneficiaries of Massachusetts Investors Trust have not had any voice in the selection of the trustees, these being designated for the life of the trust and possessing the power to fill vacancies in their number (reply to the Commission's questionnaire for Massachusetts Investors Trust, Pt. I).

[100] See Sears, John H., *Trust Estates as Business Companies*, 2nd ed. (1931) Ch. II, Secs. 16–19, and Ch. VIII. Sec. 58 et seq.; Dunn, William C., *Trusts for Business Purposes* (1922), Ch. II, Sec. 21, and Ch. V, Secs. 57–58; *Walburn* v. *Ingilby*, 1 Myl. & K. 61, 39 Eng. Reprint, 604 (1833).

[101] As early as 1854 such trusts received judicial consideration in Massachusetts. See *Attorney General* v. *Federal Street Meetinghouse*, 3 Gray (Mass.) 1, 46 (1854); 16 Fletcher, Cyc. Corp., sec. 8227.

[102] *Crocker* v. *Malley* (1919), 249 U. S. 223, 63 L. Ed. 573; *Spotswood* v. *Morris* (1906), 12 Idaho 360, 85 P. 1094, 6 L. R. A. (N. S.) 665; *Hart* v. *Seymour* (1893), 147 Ill. 598, 35 N. E. 246; *Gardiner* v. *Gardiner* (1912), 212 Mass. 508, 99 N. E. 171; *Frost* v. *Thompson* (1914), 219 Mass. 360, 106 N. E. 1009; *Merchants Nat. Bank* v. *Wehrmann* (1903), 69 Ohio St. 160, 68 N. E. 1004; Pittsburgh Wagon Works Estate (1903), 204 Pa. 432, 54 A. 316; *Betts* v. *Hackathorn* (1923), 159 Ark. 621, 252 S. W. 602; *Goldwater* v. *Oltman* (1930), 210 Cal. 408, 292 P. 624; *Schumann-Heink* v. *Folsom* (1927), 328 Ill. 321, 159 N. E. 250; *Darling* v. *Buddy* (1927), 318 Mo. 784, 1 S. W. (2d) 163; *Brown* v. *Bedell* (1934), 263 N. Y. 177, 188 N. E. 641; *Byrnes* v. *Chase Nat. Bank* (1928), 232 N. Y. Supp. 224, 225 App. Div. 102; *Rhode Island Hospital Trust Co.* v. *Copeland* (1916), 39 R. I. 193, 98 A. 273; *Narragansett Mut. Fire Ins. Co.* v. *Burnham* (1931), 51 R. I. 371, 154 A. 909; *Reilly* v. *Clyne* (1925), 27 Ariz. 432, 234 P. 35; *State* v. *Cosgrove* (1922), 36 Idaho 278, 210 P. 393; *Roberts* v. *Aberdeen-Southern Pines Syndicate* (1930), 198 N. C. 381, 151 S. E. 865; *Simson et al.* v. *Klipstein* (D. C., N. J., 1920), 262 F. 823; *Marchulonis* v. *Adams* (1924), 97 W. Va. 517, 125 S. E. 340; *Hayes Motor Truck Wheel Co.* v. *Wolff* (1925), 175 Wis. 501, 185 N. W. 512; Okla. Statutes (1931), Ch. 65, Art. 5, sec. 11823. For a complete compilation of cases dealing with the subject of business trusts see notes in 7 A. L. R. 612; 10 A. L. R. 887; 31 A. L. R. 851; 35 A. L. R. 502; 46 A. L. R. 169; 58 A. L. R. 518; 71 A. L. R. 890.

[103] Mass. Gen. Laws (1921), Vol. 2, Ch. 182, p. 2077; Okla. Statutes (1931), Ch. 62, Art. 5, secs. 11820–3; Wis. St. (1931), Ch. 226, Sec. 14.

[104] *Hect* v. *Malley* (1923), 265 U. S. 144, 147, 148, 68 L. Ed. 949, 953; other definitions will be found in the following cases: *Goldwater* v. *Oltman* (1930), 210 Cal. 408, 292 P. 624; *Kimball* v. *Whitney* (1919), 233 Mass. 321, 123 N. E. 665; *Attorney General* v. *Federal Street Meetinghouse*, 3 Gray (Mass.), 1.

of an instrument of trust to be held and managed for the benefit of such persons as may, from time to time, be the holders of transferable certificates issued by the trustees, showing the shares into which the beneficial interest in the property is divided. These certificates which resemble certificates for shares of stock in a corporation and are issued and transferred in like manner, entitle the holders to share ratably in the income of the property and, upon termination of the trust, in the proceeds.

The ostensible purpose in selecting the trust form was to secure the advantages, privileges, and immunities of corporations, to limit the liability of its contributors, and at the same time to escape the requirements of corporation statutes. However, the investors or beneficiaries or cestuis que trustent, in the absence of a specific grant of voting power, have no voice in the selection or change in the trustees or management. The freedom thus achieved by the trustees from control by the investor is, from the standpoint of the management, a most advantageous effect of this type of organization.

It has been held that the absence of personal liability on the part of shareholders beyond the amount of their subscription, which is characteristic of corporations, is conditioned upon this absence of control by shareholders in a Massachusetts trust. Thus, if these contributors are given a binding voice in the determination of the policies, they may be considered partners in a joint venture and, as such, jointly and severally liable for the obligations of the enterprise.[105]

Managers have cemented their control with the plea that to extend a voice in management to the beneficial owners would result in a loss of the legal attributes of the venture as a trust, and impose undesirable personal liability on the shareholders.[106] However, some investment trusts organized as Massachusetts trusts have given their shareholders varying voting rights. Thus, Aldred Investment Trust gave holders of 25% of the common shares the right to call a meeting for the purpose of substituting, reelecting or filling vacancies in the trustees.[107] In Consolidated Investment Trust the agreement and declaration of trust provided substantially the same voting privileges for the election of trustees at annual meetings, etc., as are accorded to stockholders by the ordinary corporate charter.[108]

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[105] See *Liquid Carbonic Co.* v. *Sullivan* (1924), 103 Okla. 78, 229 P. 561; *Simson et al.* v. *Klipstein* (1920), 262 Fed. 823. See also *Flint* v. *Codman* (1924), 247 Mass. 463; 142 N. E. 256; *Neville* v. *Gifford* (1923), 242 Mass. 124, 136 N. E. 160; *Howe* v. *Chmielinski* (1921), 237 Mass. 532, 130 N. E. 56; *Horgan* v. *Morgan* (1919), 233 Mass. 381, 124 N. E. 32; *Sleeper* v. *Park* (1919), 232 Mass. 292, 122 N. E. 315; *Dana* v. *Treasurer, etc.* (1917), 227 Mass. 562, 116 N. E. 941; *Gutelius* v. *Stanton* (1929), 39 Fed. (2d) 621; *Goubeaux* v. *Krickenberger* (1933), 126 Ohio St. 302, 185 N. E. 201; *Ittelson* v. *Anderson* (1933), 67 F. (2d) 323; *Berneson* v. *Fish* (1933), 135 Cal. App. 588, 28 P. (2d) 67.

[106] Merrill Griswold, chairman and one of the trustees of Massachusetts Investors Trust, testified (Public Examination, Massachusetts Investors Trust, at 2320–1):

> Q. And as respects Massachusetts law, this trust is a true trust in that regard?
> A. I would like to point out there—we are getting legal—that associations organized under a trust indenture can either be a strict trust or it can be a partnership. There are various federal and state cases holding that certain of these organizations are partnerships. This particular trust is not a partnership, but it is a trust. The distinction is extremely important, because in a partnership the shareholders or members are liable for the debts of the concern, and if we were a partnership our shareholders would be subject to an additional liability.
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> * * * * * * *
>
> Some mention was made of stockholders' meetings. The test between a partnership and a trust is whether the stockholders can control the actions of the trustees. If they can control they are considered as members of a partnership.

[107] See infra, pp. 1899–1901.

[108] Reply to the Commission's questionnaire for Consolidated Investment Trust, Pt. I.

In the Massachusetts type of trust where the shareholders are not given the right to vote, they are relegated, in the event of wrongful conduct by the trustees, to an equity action to remove the trustees. The trustee may only be removed by the courts upon the petition of a party beneficially interested and a showing "that such removal is for the interest of the beneficiaries of the trust; or if he has become insane or otherwise incapable or is unsuitable therefor." [109]

2. JOINT STOCK COMPANIES

A joint-stock company is essentially a form of organization, which, although neither a partnership nor a corporation, possesses many of the attributes of both. A joint-stock company resembles a partnership in that the shareholders are subject to unlimited personal liability for the obligations of the company and resembles a corporation in that for most purposes it is a legal entity independent of the shareholders. A joint-stock company resembles a Massachusetts type of trust in that there may be a substantial separation of the ownership of the fund from its control.[110]

a. The Adams Express Company

The only investment company which is a joint-stock association in form is The Adams Express Company, organized in New York in 1854 to conduct the business of express forwarding. Under the laws of New York the organizers of joint-stock associations are given large latitude in the determination of the contents of the articles of association with reference to the election of the management personnel of the company.[111] The articles of association of The Adams Express Company provided with respect to management that the

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[109] Ch. 203, Sec. 12, of the General Laws of Massachusetts. Merrill Griswold, of Massachusetts Investors Trust, testified (Public Examination, Massachusetts Investors Trust, at 2473–4):

> Q. And certainly under the laws of a great many states, in the case of dereliction of duty on the part of a director, they don't have to wait for the next annual meeting. They can go to a court of equity. But it is difficult to this extent, that they have something to say as to who shall succeed him, and in your situation they cannot say as to the successor.
>
> A. Our trust is based—as are all the investment trusts in Massachusetts—upon the old trust idea, in all trusts as distinguished from corporations, that is, testamentary trusts or living trusts or trusts of this character, that the trusts are continued subject to good behavior, and following that analogy rather than the corporate analogy.

F. Winchester Denio, a trustee of Old Colony Investment Trust, testified that he favored the trust form because of the broad powers which could be accorded to the permanent management (Public Examination, Old Colony Investment Trust, at 6111–2):

> In the first place, you have rather broader powers, which we thought were desirable, because our philosophy of an investment trust was what you were buying primarily was the integrity and judgment of management in which you had confidence, and our general theory is that if you have that confidence, you can generally pretty safely trust them with any powers that they wish to give themselves * * *.

[110] Justice O'Brien, of the Court of Appeals of New York, in *Hibbs* v. *Brown*, 190 N. Y. 167, 82 N. E. 1108 (1907), discussing The Adams Express Company, stated (190 N. Y. 186):

> A joint stock company, whatever else may be said about it, is certainly, for most, if not all, practical purposes, a legal entity, capable in law of acting and assuming legal obligations quite independent of the shareholders.

[111] The New York General Association Law provides that the articles of association may prescribe the number of directors, not less than three, to have "sole management" of the company's affairs and may contain any other provisions for management not inconsistent with law. The statute does not require annual election of directors (Cahill's Consolidated Laws of New York [1930], Ch. 20, § 3).

original board of managers of the company would continue in office "until displaced according to the articles." The only method of displacement provided was by means of a special meeting which could only be called by stockholders holding one-third of the outstanding shares. At any meeting so called, however, the concurrence of the holders of two-thirds of the outstanding shares was necessary to remove directors. Furthermore the majority of the board of managers could fill vacancies in its membership until the next meeting of the stockholders.[112]

The complexity of the procedure required to displace the management of The Adams Express Company, coupled with the difficulty of uniting widely dispersed holders of the voting securities of the company to take action to remove the directors, clearly would tend to perpetuate the management of the company. In fact, between 1854 and 1930 no stockholders' meetings were held and the board of managers itself elected all new members of the board to fill the vacancies which occurred.[113] Not until October 24, 1929 were amendments made to the articles of association to provide for annual elections of the company's directors on the vote of a specified percentage of its stockholders.[114]

Nevertheless, between 1854 and 1930 substantial changes in the nature of the business, management, management policies and the capital structure of The Adams Express Company occurred—changes which were of profound significance to the company's common stockholders who were legally liable without limit for all of the company's debts by the nature of its organization.[115] However, in the effectuation of these changes, the substantially disfranchised common stockholders of the company had little voice.

Although The Adams Express Company prospered prior to 1890, the express business thereafter became increasingly less profitable, particularly after the advent of the parcel post system in 1912.[116] Until the latter part of 1918 the entire express forwarding business of the country had been more or less divided among three companies: The Adams Express Company, American Express Company, and Wells Fargo and Company.[117] After the entrance of the United States into the World War, the Government caused the formation of American Railway Express Company, which by Government order took over the express business of the three companies.[118] The stock of the newly organized company was distributed in approximately equal thirds to each of the old express companies in consideration of the cession of their express business to the new company.[119]

As a result of this transaction, The Adams Express Company became an investment-holding company, its largest single asset being the block of about one-third of the outstanding stock of American Railway Express Company.[120] In addition it owned a 30-story building

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[112] Reply to the Commission's questionnaire for The Adams Express Company, Pt. I.
[113] Public Examination, The Adams Express Company, at 6850.
[114] Op. cit. supra, note 112, Pt. I.
[115] Op. cit. supra, note 113, at 6828.
[116] Id., at 6831.
[117] Id., at 6830–1.
[118] Id., at 6831.
[119] Id., at 6832.
[120] Id., at 6838.

at 61 Broadway, New York City, known as The Adams Building, and a large amount of marketable securities, most of which were pledged as collateral for its outstanding bonds (then aggregating $17,000,000 to $18,000,000) [121] which had been distributed originally to stockholders in the form of a bond dividend. In 1918 and 1919 commercial bankers and investment banking firms began to be represented in the management of The Adams Express Company. Albert H. Wiggin, president of The Chase National Bank of the City of New York, and Charles Hayden, a member of Hayden, Stone & Co., investment bankers and brokers, were invited to the board of The Adams Express Company, the former by reason of the banking connection and the latter by reason of the stock holdings of clients of the firm.[122] Subsequent to that time, The Adams Express Company developed rapidly into an investment company of the management type and, except for a period from 1927 to 1929, the firm of Hayden, Stone & Co. dominated its management.[123]

From 1919 to 1927, however, the management occupied itself largely with retiring the collateral trust bonds of the investment company with funds received through the liquidation of securities and the sale of The Adams Building.[124] Although The Adams Express Company did not actively represent itself to be an investment company during these years, it did maintain and manage a securities portfolio composed mainly of preferred stocks. At the end of 1927, the company had total assets at market of over $30,000,000.[125] Its management policy during this period was apparently a conservative one designed to protect the interests of the common-stock holders who, as has been stated, were unlimitedly liable for the company's debts, and The Adams Express Company was transformed without difficulty into a diversified management investment company.

In 1927 a group of individuals, Eugene W. Leake, Martin J. Alger, Adrian R. Allen, and William T. Hoops, acquired by purchases in the open market close to 50% of the outstanding common stock of The Adams Express Company and demanded and received a substantial representation on the board of managers.[126] The primary interest of this group, apparently, was so to conduct the affairs of the company as to effect as rapid an increase as possible in the market value of the common stock which it had purchased.[127] With this object in view, the group ceased retiring the company's bonded indebtedness and thus retained leverage for the common stock with comparatively low senior charges. They further modified the previous conservative investment policy of the company to embrace the purchase of common stocks, thus achieving, in addition, leverage through the securities in the portfolio.[128]

[121] Id., at 6832.

[122] Id., at 6825–6.

[123] Id., at 6826–7. Assets increased, largely through mergers and further stock offerings, to a high of $71,105,800 at the end of 1929, while the subsequent low was $17,108,966 at the end of 1932 (op. cit. supra, note 112, Pt. II).

[124] By 1927 the original bonded indebtedness of The Adams Express Company had been reduced by $8,000,000 to approximately $10,000,000 (op. cit. supra, note 113, at 6838).

[125] Op. cit. supra, note 112, Pts. I and II.

[126] Op. cit. supra, note 113, at 6840.

[127] Id., at 6842.

[128] Id., at 6842–3.

Concerning this change of policy by the group, Steele Mitchell, a member of the board of managers since October 1927 and president of The Adams Express Company since 1937, testified:[129]

A. As they expressed it to me, they felt that The Adams Express Company was pursuing the wrong policy in selling its assets and retiring its debt, that the 4-percent bonds gave great leverage to the common shares, and if The Adams [Express] Company would purchase common stocks, due to the leverage of the bonds, instead of owning bonds which had no appreciation possibilities, that very substantial amounts of money could be made for the common-stock holders.

Q. So that they saw in this situation a possibility of turning this into a leverage investment trust?

A. Precisely.

Although the common stockholders of The Adams Express Company obviously had a deep concern in this change of investment policy, they were not consulted with respect to its adoption. However, a plan was worked out whereby the common stockholders were permitted to exchange their shares for a preferred stock guaranteed against unlimited liability for the debts of the company by the remaining common stockholders.[130] This exchange also served to increase the leverage factor, as desired by the new group. Mr. Mitchell testified concerning this exchange:[131]

Q. I have also figured out that not all of the common stockholders took advantage of that, that the common stock by this exchange was reduced from 100,000 shares to 66,209.

A. That is right.

Q. And the effect of that was to increase the leverage ratio of the common stock from 2.5 to 4.5. Have you figured that out?

A. I haven't figured out those ratios, but the effect was to increase the leverage.

Q. Your capital structure was at that time $10,000,000 of bonds, $5,500,000 of preferred and $6,700,000 of common?

A. That is right.

By the early part of 1929 the members of this group had sold out the greater portion of their holdings of The Adams Express Company[132] and the company continued to operate as a general management investment company. In the latter part of 1929 The Adams Express Company absorbed American Railway Express Company, which by that time had turned into an investment company, and Haygart Corporation, another investment company, by issuing common stock in exchange for the $32,100,000 of net assets which these mergers added to the company.[133] At the end of 1936 The Adams Express Company had net assets, at market, of approximately $50,500,000.[134]

[129] Id., at 6842.

[130] Ibid.

[131] Id., at 6847.

[132] Id., at 6852.

[133] Id., at 6878 and Commission's Exhibits Nos. 631, 632, and 633. Haygart Corporation was organized and dominated by the investment banking firms of Hallgarten & Co. and Hayden, Stone & Co. (ibid.).

[134] Op. cit. supra, note 113, at 6989–90.

Although The Adams Express Company was organized as an express company the successive managements made no effort to alter its form of organization when it assumed the characteristics of an investment company. It must therefore be assumed that these managers considered the joint-stock association to be a satisfactory vehicle for their needs. Furthermore, the successive managements gained and retained control without the necessity for the ownership of the majority of the common stock while the common stockholders were subjected to unlimited liability for the obligations of the organization.

C. Control Through Voting Potentialities

1. OPTION WARRANTS

A device sometimes employed by the sponsors of investment companies to insure the perpetuation of their control was to cause the companies to issue to the sponsors option warrants for the purchase of large blocks of voting shares. These warrants were issued in exchange for management services, as underwriting commissions, for cash, or gratis.[135] In most instances the acquisition of these option warrants required little or no initial cash outlay by the sponsors. Thus, from the outset the sponsor group was fortified against any threat to its control since it could always exercise sufficient of these warrants to insure adequate voting power. In fact, the mere ownership of these option warrants served to forestall any attempt to oust the sponsor group from control.

When examined on this use of option warrants as a means of strengthening a position of control of investment companies, Louis G. Bissell, a member of the law firm of Chadbourne, Stanchfield and Levy, which acted as counsel for Haygart Corporation, an investment company, testified:[136]

Q. Well, now, how about in this particular case, what does your business experience tell you of the desirability of a continuing 40% option for management compensation, of this nature? What do you see as the advantages and what do you see as the disadvantages?

A. * * * it wasn't offered as a bonus stock, but these gentlemen organized this company and they candidly stated that, and therefore they were sponsoring this particular organization.

Now, it was desirable that the organization should continue to have them available to it, and inasmuch as they had gone to the effort of organizing it, it was desirable for them to keep some contact with it, and these options did give them the opportunity to have 40% of the stock throughout its life, if they wanted it, and I assume that as practical matter, 40% of the stock would have been tantamount to control.

In Second General American Investors Company, Inc., its sponsors, Lazard Frères and Lehman Brothers, although possessing complete voting control from the outset, nevertheless had the investment company issue to themselves a large block of 25-year option warrants,

[135] Of 204 investment companies 58 gave option warrants and 5 gave stock to management without payment in cash or property (Pt. Two [House Doc. No. 70, 76th Cong.], Ch. III, pp. 203–6).

[136] Op. cit. supra, note 113, at 6901.

apparently as an additional precaution. Raymond D. McGrath, a partner in Lazard Frères and an officer and director in General American Investors Company, Inc., testified: [137]

> Now, the 25 years grew out of the following line of thought: we had issued securities like those preferred stocks and bonds in the first company. They were long-term obligations. We were responsible for the management of this company. We said long warrants, because we said as long as those warrants are outstanding in the hands of Lazard and Lehman there is no danger of anybody getting control of this company. It insures the control. That is why we wanted that length of time.

These 25-year option warrants, which were never intended for public distribution and which were not exercised,[138] may be contrasted with 5-year option warrants issued as a sweetening with senior securities sold to the public.[139]

While option warrants of investment trusts and investment companies at one time enjoyed a market price well in excess of the difference between the prices at which they could have been exercised and the asset values of the common shares obtainable, sponsor interests appeared reluctant to surrender this insurance against loss of control. Such option warrants represented a constant threat of dilution to existing stockholders during the periods that the exercise price was less than the asset values of the common shares obtainable, while they served to impede recapitalizations and mergers when they represented no equity value.

a. National Investors Corporation

Option warrants played an important part in the pyramiding of the investment companies comprising the National Investors Corporation group. On June 16, 1927, Fred Y. Presley organized National Investors Corporation. The plan of operation was that this company would be owned substantially by Guardian Detroit Company, Inc. of Detroit, Michigan, and its banking contacts, and that the company would operate as the sponsor and manager of a series of subsidiary investment companies to be formed thereafter.[140]

The principal control device employed was the issuance of option warrants to sponsor interests. National Investors Corporation issued 40,000 units at \$110 a unit, each comprised of one share of 5½% cumulative preferred stock, one share of common stock, and a 10-year option warrant to purchase 1½ shares of common stock at prices ranging from \$10 to \$20 a share. Similar option warrants for 100,000 shares of common stock were received by Guardian Detroit Company, Inc. as underwriting compensation.[141] These option warrants acquired by the sponsor, representing the potential power to acquire 50% of the investment company's voting stock without necessitating any immediate investment by the sponsor, were apparently sufficient to curb any effort to displace the sponsor from control at that time.

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[137] Public Examination, General American Investors Company, Inc., at 5714, 5749.

[138] Id., at 5750, 5774.

[139] For further details, see Ch. III of this part of the report, pp. 942–52.

[140] For further details see supra, pp. 1608–14 and Ch. III of this part of the report, pp. 887–91.

[141] Public Examination, National Investors Corporation, at 4263.

Thereafter, Guardian Detroit Company, Inc. reallocated half of its option warrants to persons and organizations who had aided in the sale of the units of National Investors Corporation or were to go on the board of directors.[142] However, Guardian Detroit Company, Inc. retained the potential control represented by these option warrants by agreements granting this sponsor a first call upon the options for 30 days should the recipients decide to dispose of them and by the reservation of the right to exercise full voting power of any stock issued under the options.[143]

Mr. Presley testified as to this arrangement as follows: [144]

Q. Just what was the string that Guardian Detroit had upon all these option warrants which were distributed to organizers?

A. First, organizers were required to offer their options to Guardian, I think for a period of 30 days, and if Guardian did not exercise its rights to purchase those options, they could then be sold by the holders of the options.

Q. At the market, generally?

A. Yes; and, second, in the event any of these organizers options were converted into stock, that Guardian would have the right to vote that stock.

Q. Was there a voting trust agreement set up to take care of that contingency?

A. No; I think it was just written across the face of the certificates.

Q. So that it really was a hedge on the negotiability of the certificates?

A. Yes.

Q. What was the purpose of restricting the voting rights of the stock, assuming the warrants were exercised, to Guardian Detroit?

A. I think Guardian felt it was to the best interest of the company to continue in control during the formative period.

By this device Guardian Detroit Company, Inc. apparently was protected against any threat to its control without the necessity for any immediate investment by it in the investment company.

The formation of three subsidiary investment companies with total paid-in assets of $48,200,000, namely, Second National Investors Corporation, Third National Investors Corporation and Fourth National Investors Corporation, in which the use of option warrants became of increasing importance to the sponsor as the device of control, followed in rapid succession upon the organization of National Investors Corporation, the parent company in the group. National Investors Corporation contributed $1,000,000 to Second National Investors Corporation for which it received 100,000 shares (or one-third) of the common stock and all of the option warrants for 200,000 common shares exercisable for 15 years at $25 a share. The public distribution consisted of 100,000 preferred shares and 200,000 common shares. Another $1,000,000 was invested in Third National Investors Corporation in payment for 20,000 common shares (out of 220,000 common shares issued) and all of the option warrants to purchase 130,000 common shares, which were exercisable for 10 years at $60 a share. Twenty-eight thousand of these warrants were redistributed to members of the selling group as an inducement for greater sales efforts. Finally, $3,000,000 was invested in Fourth National Investors Corporation for 10-year option warrants to purchase 750,000 shares at $60 a share.

[142] Id., at 4268–9.
[143] Id., at 4344.
[144] Id., at 4344–5.

while the public subscribed to 500,000 common shares and 250,000 option warrants.[145]

Two significant facts characterized the investment policy of the parent company. First, National Investors Corporation at all times owned or held under option sufficient shares to assure its effective control over each subsidiary company, although it possessed no capital with which to exercise the option warrants should the need have arisen. Second, the amount of common stock investment diminished with each new company until the investment of National Investors Corporation in Fourth National Investors Corporation was in the option warrants alone.[146] In addition, National Investors Corporation entered into 5-year management agreements terminable upon one year's notice with its various subsidiaries.[147] These agreements, which provided another tie with the parent company, were terminated on December 31, 1934.[148]

With the decline in security values, these option warrants no longer represented a practical safeguard to control. Atlas Corporation in its program of acquisition of control of other investment companies began to acquire over the period 1931–1933 large blocks of the stock of National Investors Corporation and affiliated companies with the apparent purpose of absorbing the National Investors Corporation group of investment companies.[149] When the management of National Investors Corporation refused its cooperation in the contemplated exchange offers,[150] Atlas Corporation allowed its holdings in Second National Investors Corporation and Third National Investors Corporation to be repurchased by those companies and transferred its interest of 145,000 shares in National Investors Corporation to Hayden, Stone & Co., which brought the holdings of that firm to some 160,000 shares.[151] As a result, Hayden, Stone & Co. was able to obtain representation on the board of National Investors Corporation through its nomination of a nonaffiliated director.[152]

Since 1930, consideration had been given to the possibility of merging the various companies comprising the National Investors Corporation group to form a single, open-end investment company.[153] While the correlation of the various common stocks may have presented some technical problems, a real difficulty arose from the existence of the option warrants which possessed only a most speculative value based upon the possible increase in the value of the common shares above the prices at which the warrants were exercisable.[154]

[145] Op. cit. supra, note 140.

[146] A similar structure and investment by the parent company was planned in a projected Fifth National Investors Corporation (op. cit. supra, note 141, at 4326–7). This venture was abandoned because of unfavorable market conditions in the fall of 1929 (id., at 4328).

[147] Op. cit. supra, note 141, at 4304, 4319, and Commission's Exhibit No. 425.

[148] Id., Commission's Exhibit No. 425, and replies to the Commission's questionnaire for Third National Investors Corporation, Pt. I and Fourth National Investors Corporation, Pt. I.

[149] Op. cit. supra, note 141, at 4515–29.

[150] Id., at 4527–8.

[151] Id., at 4730–45 and Ch. III of this part of the report, pp. 997–9.

[152] Ibid. However, the effort of other stockholders to secure representation on the board of Fourth National Investors Corporation was effectively blocked by the management (op. cit. supra, note 141, at 4480–1).

[153] Op. cit. supra, note 141, at 4439.

[154] Id., at 4447.

Thus, while these option warrants constituted no substantial source of new capital, they did offer serious impediments to the consummation of the merger plans.

A plan of merger, which would have required preferred stockholders of Second National Investors Corporation to surrender a part of their asset value of the common shareholders who in turn were to give up a portion of their asset values in order to create a value for the warrants [155] was finally blocked by the shareholders of Fourth National Investors [156] on the ground that too liberal an allowance had been made for the warrants owned by the parent company.[157] Merger arrangements were finally reached in 1937 under which the warrants were accorded some participation and by virtue of which their existence as a threat to control was removed.[158]

2. CONVERTIBLE SECURITIES

The issuance of senior securities with the right of conversion into voting shares was another device, somewhat akin to the use of option warrants, by which sponsors of investment companies could assure themselves of sufficient potential voting power against the contingency of any threat to their control position.[159] This conversion privilege was usually attached to bonds and preferred stock and in no small measure was designed to assist in the marketing of these senior issues. The sales appeal of this conversion privilege consisted in offering to the investor in addition to a senior position, the opportunity of an equity participation above the usual fixed interest or dividend rates of the senior securities.[160] However, the conversion privilege constituted a means by which sponsors could obtain a senior position which at the same time would safeguard their control. As stated by one author: [161]

> The literature of finance abounds with instances in which convertible bonds are authorized and issued by a corporation for the purpose of insuring a potential increase of stock interest by certain individuals * * * a concentrated and coordinated minority interest, in control of a corporation may, by buying and holding convertible bonds, insure the perpetuation of the control without the loss of interest involved in holding a block of non-dividend-paying common stock.

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[155] Id., at 4443–54.

[156] Id., at 4455, 4464.

[157] Id., at 4475–6.

[158] Derived from supplementary information supplied the Commission for National Investors Corporation. For discussion of earlier merger plans see op. cit. supra, note 141, at 4439 et seq. See also Ch. IV of this part of the report, pp. 1458–98.

[159] It has been held that the issuance of convertible securities violates stockholders' preemptive rights. See *Wall* v. *Utah Coffee Co.* (1905), 70 N. N. Eq. 17, 62 A 533.

[160] "* * * with few exceptions * * * the convertible security is created in order to meet the public demand for an investment combining apparent safety of principal with speculative opportunity for enhancement in price. Its value is therefore the resultant of two distinct and incommensurable factors—certainty and chance of appreciation. One represents the value of the security by reason of its inherent strength as a direct obligation of the corporation. * * * The other element represents the value attaching to the privilege of convertibility" (Dewing, Arthur Stone, *A Study of Corporation Securities* (1934), p. 412).

[161] Dewing, Arthur Stone, *A Study of Corporation Securities* (1934), pp. 385–6.

Of the 33 management investment companies analyzed which issued bonds or debentures, nine of these companies had bond or debenture issues which carried the conversion privilege exercisable at the option of the holder. Similarly, 30 management investment companies authorized the issuance of preferred stock convertible into common stock.[162]

a. Aldred Investment Trust

The potentialities of control through the conversion of sponsor-held senior securities is illustrated by Aldred Investment Trust, organized in November 1927 as a Massachusetts trust by Aldred & Co., investment bankers.[163] As a result of subscription to the investment company's initial issues, the public held $5,000,000 in debentures with 50,000 shares of nonseverable common stock, while the sponsor at a cost to it of $1,125,000, held 10,000 shares of preferred and 50,000 shares of common stock.[164] Thus at the inception of the trust, the power to elect and perpetuate the trustees was equally divided between the public and the sponsor, Aldred & Co.[165]

Under the terms of the Agreement and Declaration of Trust which governed the operation of Aldred Investment Trust, voting privileges were denied to the senior securities but awarded to the holders of the common stock. Vacancies among the trustees were to be filled by the remaining trustees, provided, however, that the holders of not less than 25% of the common shares then entitled to vote could call a meeting of the holders of the common shares and by vote of the holders of a majority of the outstanding common shares the trustees or any of them could be superseded or reelected or a new trustee or trusteees elected to fill any vacancy that may have existed.[166]

In May 1928, when Aldred Investment Trust contemplated the issuance of an additional $5,000,000 in debentures to be sold in units of one debenture and ten shares of common stock,[167] the device of conversion was utilized by Aldred & Co. The sponsor-held preferred stock was not convertible as originally issued.[168] A resolution, adopted by the trustees providing for the convertibility of this preferred stock into common stock,[169] was then submitted to the common stockholders for approval, dominant among which stockholders was the sponsor by virtue of its large block of common shares.[170] This conversion had the effect of increasing the holdings of Aldred & Co. in the investment company's common stock from 50,000 to 112,500 shares or to more than 50% of the total voting stock outstanding.[171]

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[162] It was frequently the practice to authorize the issuance of preferred shares in series and to allow the board of directors to determine the conversion and other privilege which should attach to each issue.

[163] Reply to the Commission's questionnaire for Aldred Investment Trust, Pt. I.

[164] Public Examination, Aldred Investment Trust, at 19118–9, 19124, and 19126.

[165] Id., at 19124.

[166] Op. cit., supra, note 163, Pt. I (Agreement and Declaration of Trust, at 3).

[167] Op. cit. supra, note 164, at 19125, 19127.

[168] Op. cit. supra, note 163, Pt. I, and op. cit. supra, note 164, at 19125.

[169] Op. cit. supra, note 164, at 19125.

[170] Id., at 19093, 19125–6.

[171] Id., at 19127–32. These 112,500 shares had an asset value at the time of $1,535,000 as compared with $1,125,000 in actual cost to the sponsor (ibid.).

3. UNIT SALES AND PART-PAID SECURITIES

The distribution of securities of investment companies in units—offering senior securities and junior securities, either as a package or as an allotment certificate—was another device employed by sponsors to secure control of these organizations.

While the practice of offering securities in units was essentially a selling device,[172] the combination of junior with senior securities usually assured a wide distribution of the junior issues in the first instance and served to "freeze" this wide distribution until the units became severable. Thus, any outsider seeking to obtain control of the investment company by acquiring the necessary junior voting stock would have also to purchase the senior securities tied up in the units. The sponsors, however, sometimes issued the junior voting shares to themselves free from this unit tie-up.[173] The sponsors were thereby afforded a period of time between the issuance of the units and the date these units were declared severable during which the sponsors could entrench themselves in control.

Much the same advantage is obtainable by issuing the shares of the investment companies upon a part-paid basis, provided the voting powers of these shares are denied to their holders during the period that they are not fully paid for. By this method voting securities can be sold to the public with installments payable at certain fixed dates or at the discretion of the board of directors. The sponsors may thus be accorded the opportunity to cement their control during the early existence of their investment companies.

4. ELIMINATION OF STOCKHOLDERS' PREEMPTIVE RIGHTS

Unless adequately circumscribed in the interest of stockholders, the power of managements to issue additional shares of the voting securities of investment companies may be a source of substantial loss to the stockholder as well as a device to perpetuate the control of the management.[174] An unrestricted power of the management to issue

[172] See Ch. III of this part of the report, pp. 909–11.

[173] At the formation of Central-Illinois Securities Corporation, in October 1929, sponsors purchased 600,000 shares of voting common stock at $5.00 per share, and the public purchased 400,000 shares of voting preferred stock in units with 400,000 shares of voting common stock at a price of $31.50 per unit. These units were represented by allotment certificates convertible into stock of the company on and after November 1, 1931. While the sponsors' holdings, which represented 43% of the total voting power of the company, undoubtedly constituted practical control, nevertheless the resulting wide distribution of the publicly held stock and the average cost of $15.75 per vote to the public as compared with a cost of $5.00 per vote to the sponsors served as an added assurance to the latter's control. (See Ch. II of this part of the report, pp. 142–181.)

[174] The courts have held, irrespective of the existence or nonexistence of a preemptive right in the stockholders to be given the first opportunity to subscribe to all subsequent issues of the company's stock, that directors, as the fiduciaries of the stockholders, may not issue stock to themselves, particularly at unfair prices, solely for the purpose of perpetuating their control. 11 Fletcher, Cyclopedia Corporations (1932), secs. 5315 and 5160; *Dunlay* v. *Avenue M. Garage & Repair Co. Inc.*, 253 N. Y. 274, 170 N. E. 917 (1930). A similar rsult has been reached by the courts where a controlling stock has been sold to interests friendly to some or all of the directors. *Luther* v. *C. J. Luther Co.*, 118 Wis. 112, 94 N. W. 69 (1903); but cf. *Wildes* v. *Rural Homestead Co.*, 54 N. J. Eq. 668, 35 Atl. 896 (1896). However, for the stockholder to secure relief against activities of this type upon the part

additional shares would vest in the management the ability to transfer control of the corporate assets to others—a power over the corporate assets of substantial consequence to the stockholders. The management could sell shares to insiders and other friendly persons at prices substantially less than the asset and market value of such shares,[175] thus causing a dilution in the asset values of the existing shares and possibly a decline in the market value of the existing shares because of the increased supply of the stock made available for sale in the market. In addition, the issuance of further shares having voting power would dilute the proportionate voting power of the existing stockholders and to that extent weaken their ultimate control over the management and property of the corporation. In sum, it would be possible for the management, by selling shares to persons other than the original stockholders or their successors, not only to dilute the asset participation and voting power of such stockholders but to deprive them of an opportunity to invest additional funds at attractive prices in a prosperous enterprise founded with their money and in which they assumed the initial risk of loss.[176]

These possibilities of overreaching inherent in an unrestrained power in managements to dispose of additional shares of the corporation stock induced the courts, comparatively early in the history of corporate law, to place some restrictions thereon. The courts have ruled that in certain circumstances existing stockholders must be given the first opportunity to purchase additional issues of the corporation's stocks, a privilege commonly referred to as the preemptive right of stockholders.[177] This doctrine has also been implemented by the general principle of equity that, apart from the existence or nonexistence of a pre-emptive right in given situations, directors and dominant stockholders may not use this power to issue additional stock to their own advantage or to the advantage of their associates and to the detriment of the stockholders.[178]

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of the management requires first the ascertainment of the fact of the sale of additional controlling blocks of stock to the directors or to allied interests for such purposes and second, to resort to the courts, a procedure which may be so expensive as to be beyond the means of the stockholders.

[175] "It should be noted also that one of the ways by which a corporate management secures additional power for itself is by inserting in the constitutive corporate documents clauses 'waiving' or contracting away the preemptive right. Stock bought under such charters is apt to be worth less and to increase in value less swiftly, than stock issued under charters giving the holder his full preemptive right. If the management is able to give to its associates or to outsiders the right to invest new capital at a demonstrated high rate of return, they have in their power an instrument of considerable value" (Berle, A. A., *Cases and Materials in the Law of Corporation Finance* [1930], p. 310).

[176] In *Hammond* v. *Edison Illuminating Company of Detroit, 131 Mich.* 79, 90 N. W. 1040 (1902), the court, in holding that existing stockholders had a preemptive right to subscribe for newly authorized capital stock at its par value and not, as the directors contended, at its higher market value, stated at p. 85:

> It would seem from these authorities that the right to subscribe for any increase of stock at par if he desires to do so, or to sell that right if he does not desire to exercise it himself, is one of the rights acquired by the stockholder when he becomes a subscriber to the stock. If the business is profitable the stock may be worth much more than par. If it is, it becomes so because of the investment and use of the money put into the business by the original stockholders, and we can see no hardship done to anyone when this fact is recognized.

[177] This doctrine was evolved as early as 1807 by the Massachusetts Supreme Court in *Gray* v. *President, Directors & Company of Portland Bank* (1807), 3 Mass. 363.

[178] See the authorities cited in note 174, supra, and 11 Fletcher, Cyclopedia Corporations (1932), secs. 5135 and 5150.

To invoke the general principles of equity the stockholders must seek judicial relief and assume the perhaps difficult burden of proving a breach of fiduciary duties upon the part of the management. However, the existence of a pre-emptive right imposes an affirmative duty upon the management to offer additional shares to stockholders. To recover for a breach of this right the stockholders need only prove the issuance of additional shares and the failure to grant the pre-emptive right. The pre-emptive right is thus a relatively effective weapon for the protection of the stockholder against dilution of his proportionate ownership and voting interest in his company.[179] But such right has usually been held to apply only when an increase in the capital stock would effect a dilution in the voting rights and asset participations of existing common stock and of existing preferred stock which has full voting power and a participating interest beyond its fixed preferences in the corporation's assets and earnings.[180]

The preemptive right clearly applies to issues consisting of a newly authorized increase in capital stock,[181] but a divergence of opinion exists among the courts as to whether or not the right applies to previously authorized but unissued stock.[182] If the right is held to be nonexistent in such cases the rule can be evaded by managements with ease simply by authorizing more capital stock than it is contemplated to issue immediately. However, the recent tendency of the courts seems to be to permit the preemptive right as to authorized but unissued stock which is held in reserve to meet the needs of future expansion of the corporate business but not as to authorized but unissued stock which it is planned will be sold within a reasonable time to raise the contemplated initial capital of the corporation.[183] It is thus probable, where the preemptive right has not

[179] The rationale of the courts in evolving the preemptive right has been grounded on the possible diluting effect of additional issues of shares on the asset participation and voting rights of existing stockholders. Little attention has been paid by the courts to the possible economic justification for permitting stockholders who have assumed the initial capital risks in the enterprise to subscribe to additional stock having attractive investment possibilities when the corporation has become successful irrespective of any possible diluting effects on their existing stock as the result of the issuance of more shares. (See Berle, A. A., *Cases and Materials in the Law of Corporation Finance* (1930), pp. 309–310.)

[180] 11 Fletcher, Cyclopedia Corporations (1932), Sec. 5135–6. *Yoakum* v. *Providence Biltmore Hotel Co.*, 34 F. (2d) 533 (D. C. R. I. 1929) ; *General Investment Co.* v. *Bethlehem Steel Corporation*, 88 N. J. Eq. 237, 102 A. 252 (1917) ; *Jones* v. *Concord and Montreal R. Co.*, 67 N. H. 119, 30 A. 614 (1892) ; id., 67 N. H. 234, 38 A. 120 (1892) ; *Thomas Branch & Co.* v. *Riverside & Dan River Cotton Mills*, 139 Va. 291, 123 S. E. 542 (1924). In the Yoakum case, supra, it was said that the preemptive right has never been extended to nonparticipating preferred stocks having a special and limited voting right. It has been held (see Bethlehem Steel Corporation case, supra, that a preferred stockholder had no preemptive right to purchase his pro rata share of an additional issue of preferred stock alike in all respects to the existing preferred stock except that the new preferred stock (which had no right to vote) was preferred as to dividends over the existing preferred stock and was convertible into nonvoting equity securities. See also, Berle and Means, *The Modern Corporation and Private Property*, p. 176.

[181] 11 Fletcher, Cyclopedia Corporations (1932), secs. 5135–6. See also *Miles* v. *Safe Deposit & Trust Company*, 259 U. S. 252, 66 L. Ed. 926; *Stokes* v. *Continental Trust Company*, 187 N. Y. 287, 78 N. E. 1090.

[182] 11 Fletcher, Cyclopedia Corporations (1932), sec. 5160.

[183] Ibid., and *Dunlay* v. *Avenue M Garage & Repair Co.*, 253 N. Y. 274, 170 N. E. 917 (1930), in which the court said:

> In respect to the balance of shares constituting the initial authorized issue, as distinguished from new shares, the case is different. The subscribers ordinarily take such shares with the clear understanding that the subscription shall be completed before they rely on the preservation of their proportional status. The understanding may, how-

been waived by charter provisions, that such right would attach to authorized but unissued shares of an investment company which announced by a prospectus offering its securities or otherwise that it proposed to inaugurate its existence by the sale of a fixed number of shares less than the number authorized.[184]

The preemptive right as it exists at common law, however, has been generally held not to apply to the reissuance of treasury stock, that is, stock which has been previously issued and reacquired by the corporation but not retired. It is apparent that the existence of this exception can be abused by corporate managements.[185] In fact, the courts have required that treasury stock must be disposed of at a price which will not result in a dilution of the asset participations of existing stockholders.[186]

It is also commonly stated that the preemptive right is not available where additional stock is issued for other than a cash consideration, that is, for property, although no large body of persuasive legal authority exists for this view.[187] In support of this position it is urged that a requirement for offering additional stock to the stockholders to raise cash to purchase property for corporate purposes will often hamper the management in acquiring desirable assets

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ever, be otherwise. The issued stock may be related to the unissued stock as stock for immediate issue to stock for future expansion. In such case the preemptive right might not be denied. It has been too loosely stated that a corporation may use its original unissued capital stock for any legitimate or lawful purpose it sees fit.

[184] For example, The Goldman Sachs Trading Corporation, with an authorized capital of 2,500,000 shares, offered 1,000,000 of such shares to the public in December 1928, the prospectus stating that "the corporation will commence business with $1,000,000 in cash arising from the sale of 1,000,000 shares of its capital stock" (Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1656). Under the doctrine of the Dunlay case it would seem that, unless the charter eliminated the preemptive right, the preemptive right would attach to the remaining 1,500,000 shares of the authorized but unissued capital stock of the corporation. The certificate of incorporation of The Goldman Sachs Trading Corporation, however, eliminated the preemptive right (id., Commission's Exhibit No. 1652, at 6). Nevertheless, as a condition to the listing of the 1,000,000 shares of its stock on the New York Curb Exchange, the management of The Goldman Sachs Trading Corporation was required to grant a preemptive right to the stockholders "where feasible." Notwithstanding this fact, The Goldman Sachs Trading Corporation, through the facilities of the exchange, sold an additional 125,000 shares of its stock to the public at market prices higher than the price at which the original 1,000,000 shares had been offered to the public without first offering such shares to its existing stockholders. By depriving the original stockholders of their preemptive right, the corporation thus deprived its original stockholders of the possibilities of a personal market profit which they might have obtained if the preemptive right had been awarded to them. (See Ch. III of this part of the report, pp. 917–27.)

[185] An example of the possible injurious effect upon stockholders of this power of the management to reissue treasury shares without first offering them to existing stockholders is afforded by Aviation Securities Corporation, discussed infra, p. 1910.

[186] *Borg* v. *International Silver Co.*, 11 F. (2d) 147, C. C. A. (2d) 1925; *Hammer* v. *Werner*, 239 App. Div. 38, 265, N. Y. Supp. 172 (2d Dept. 1933). The reasoning of the courts in denying the preemptive right to treasury stock is apparent from the following statement in the *Borg case*, supra, at 151:

> When a person buys into a company with an authorized capital, he accepts that proportion of the voting rights which his purchase bears to the whole. This applies certainly so far as the other shares are issued at the same time, and perhaps, also, though they are issued much later. But treasury shares have by hypothesis once been issued and have diluted, as it were, the shareholders' voting power ab initio. He cannot properly complain that he is given no right to buy them when they are resold, because that merely restores the status he originally accepted. All he can demand is that they shall bring to the corporate treasury their existing value. If they do, his proportion in any surplus is not affected.

[187] See Berle, A. A., *Cases and Material on the Law of Corporation Finanue* (1930), pp. 344–5; Berle and Means, *The Modern Corporation and Private Property* (1935), pp. 145–6.

where the opportunity must be quickly exercised. However, this rule opens an easy avenue for evasion of the salutary effects of the preemptive right in preventing dilution of the assets and voting participation of the existing stockholders.[188] For example, this rule may not prevent the common management of two investment companies from causing one company to acquire the assets of the other company, on favorable terms for the management's holdings of the securities of the acquired corporation, but on terms which will dilute the asset participation of the stockholders of the purchasing corporation.[189]

With respect to the price which may be fixed for the issuance of additional shares to which the preemptive right attaches, the courts have stated that the management or the majority stockholders may fix a reasonable price in relation to existing market and other values.[190] However, the ability to fix the price of new issues gives the management a power completely to negate the preemptive right for purposes of its own.[191]

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[188] See Berle and Means, *The Modern Corporation and Private Property,* p. 145.

[189] Compare the exchange offer made in 1930 by General Investment Corporation for the securities of United States and Overseas Corporation described in detail in Ch. II of this part of the report, pp. 497–623, and Ch. IV, pp. 1410 et seq. However, although the preemptive right may not apply to issuances of stock for property, on general principles of equity stockholders may have a remedy against managements which derive a personal advantage as a result of the issuance of stock for property. See the authorities cited in note 174, supra.

[190] In *Hammond* v. *Edison Illuminating Co.,* note 176, supra, the court held that the stockholders were entitled to subscribe to new stock at its par value and not at the existing market value which was fixed by the shareholders, although the market value was higher than the par value. In *Stokes* v. *Continental Trust Co.,* 186 N. Y. 285, 78 N. E. 1090 (1906), in upholding the plaintiff's right as a stockholder to subscribe to a proportionate share of an increase in defendant's capital stock, the court stated:

> The new stock belonged to the stockholders as an inherent right by virtue of their being stockholders, to be shared in proportion upon paying its par value or the value per share fixed by vote of a majority of the stockholders, or ascertained by a sale at public auction.

Although the court did not define a reasonable price, the stock involved was offered at a price above both its par and asset values but at less than its then market value. However, in *Scheirich* v. *Otis-Hidden Company,* 204 Ky. 289, 264 S. W. 755 (1924), the court held the new stock may be offered at its par value to existing stockholders even though the asset value was substantially higher than the par value of the stock, and even though stockholders who were unable to exercise their preemptive rights would suffer a dilution in asset value as a result of the new issues. The court stated, however, that a stockholder might be compensated for all or part of his loss in asset value by the sale of his right to subscribe for the new stock. For various terms and conditions which may be attached to the exercise of the preemptive right, sec. 11 Fletcher Cyc. Corp., sec. 5138.

[191] An example of the harm which may result to stockholders as the result of the use of this power by managements is afforded by the case of Chain & General Equities, Inc., a leverage investment company sponsored in 1929 by Childs, Jeffries & Co., Inc., of Boston. By September of 1931, the investment company had suffered substantial losses and its common stock had no asset value, and only a nominal market value ranging from $1 to $1.75 per share. At that time Wallace Groves entered into negotiations for the acquisition of control of Chain & General Equities, Inc., with William B. Nichols & Co., the successor firm to Childs, Jeffries & Co., Inc. This firm apparently had no controlling stock interest in the investment company. However, on the agreement of Mr. Groves to compensate the firm for its services in transferring control of the investment company to Mr. Groves by a cash payment, the purchase of the firm's worthless option warrants to purchase common stock of Chain & General Equities, Inc., and the grant to the firm of a management contract with Chain & General Equities, Inc., after control passed to Mr. Groves, William B. Nichols & Co. agreed to cause Chain & General Equities, Inc., to issue a controlling block of newly authorized stock to Mr. Groves. However, the stockholders of Chain & General Equities, Inc., under the common law principles which have been stated, had a preemptive right to

Nevertheless, the preemptive right as it exists at common law, although perhaps imperfect from the viewpoint of stockholders, afforded them at least some protection. However, at common law the preemptive right can be waived by provisions inserted in the corporate charter prior to the public sale of the corporation's securities. The recent tendency has also been for states with so-called "liberal" incorporation laws expressly to authorize by statute the elimination of the preemptive right by provisions in corporate charters.[192] Stockholders are presumed to be aware of these provisions and to accept them by becoming stockholders.[193] In fact, however, the stockholders may be unaware of such a provision since few stockholders actually read corporate charters and even if they are aware of such a provision they may not understand its significance.[194]

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purchase new issues of the corporation's stock, as this right had not been eliminated in the company's charter. Accordingly, the agreement between Mr. Groves and Chain & General Equities, Inc., provided that the authorized number of shares of common stock of Chain & General Equities, Inc., was to be increased and that 470,400 of the increased number of shares were to be offered to the company's common stockholders at $2 a share. Mr. Groves undertook to purchase on November 4, 1931, at this price all unsubscribed shares plus any additional shares necessary to give him 51% of the total outstanding voting power. However, this right of the stockholders to subscribe was an illusory one. Inasmuch as the common stock of Chain & General Equities, Inc., then had no asset value, and its market price at that time was $1 bid, $1.75 asked, it was probably surmised that the stockholders would not exercise their subscription rights and that Mr. Groves would be permitted to purchase all of the newly issued stock. In fact, only 2,462 shares of the new issue of common stock were purchased by the stockholders of Chain & General Equities, Inc., and Mr. Groves was therefore enabled to purchase 467,938 shares of such stock, or approximately 72% of the voting power of Chain & General Equities, Inc. With this control Mr. Groves was enabled by self-dealing with the assets of Chain & General Equities, Inc., to derive substantial personal profits at the expense of the preferred and minority common stockholders of the company, who eventually suffered substantial losses on their investment in the company. (See Ch. II of this part of the report, pp. 181–227.)

[192] Delaware Revised Code (1935), c. 65 § 5 (10). For example, in 1927 the Delaware legislature, at the suggestion of New York corporation attorneys representing investment bankers and the managements of large corporations, adopted among other amendments, an amendment to its corporation law authorizing the inclusion of provisions in the certificates of incorporation to limit or deny to the stockholders the preemptive right to subscribe to any or all additional issues of stock of the corporation of any or all classes. (Berle, *Investors and the Revised Delaware Corporation Act* [1929] 29 Col. L. Rev. 563–4).

[193] A comprehensive charter provision waiving the preemptive right is the following:

> No stockholder shall be entitled as a matter of right to subscribe for, purchase, or receive any shares of the stock or any rights or options of the * * * Corporation which it may issue or sell, whether out of the number of shares authorized by this [charter] or by amendment thereof or out of the shares of the stock of the * * * Corporation acquired by it after the issuance thereof, nor shall any stockholder be entitled as a matter of right to purchase or subscribe for or receive any bonds, debentures, or other obligations which the * * * Corporation may issue or sell that shall be convertible into or exchangeable for stock or to which shall be attached or appertain any warrant or warrants or other instrument or instruments that shall confer upon the holder or owner of such obligation the right to subscribe for or purchase from the * * * Corporation any shares of its capital stock. But all such additional issues of stock, rights, options, or of bonds, debentures, or other obligations convertible into or exchangeable for stock or to which warrants shall be attached or appertain or which shall confer upon the holder the right to subscribe for or purchase any shares of stock may (to the extent permitted by law) be issued and disposed of by the Board of Directors to such persons and upon such terms as in their absolute discretion they may deem advisable.

[194] See also op. cit. supra, note 188, p. 138, where it is stated:

> The charter actually contemplates that every stockholder will be bound by it and by any modification of it and by the general incorporation act, and by every modification of that. Such stockholders are, in large measure, about to be drawn from the general investing public, who are not represented when the charter is drawn: while the incorporating group is likely to represent the interests of those who intend to maintain control of the corporation when formed, the respective rights and powers of each will, in large measure, be defined by this charter; the result being that a so-called "contract" intended to govern the rights of two sets of parties is drawn exclusively by one party who naturally considers his own interest. The other party not only does not participate in the negotiations but in practice never even sees the document. This nat-

It has been said that, because of the vastly increased complexity of the modern corporate stock structure with its multiplicity of classes of stock with varying voting and participating rights, the existence of preemptive rights might result in litigation and other difficulties because of the impossibility of measuring accurately the extent to which participating and voting interests of existing stockholders may be affected by additional issues of shares of varying classes.[195] In other words, complex capital structures, the validity of which, at least in the case of investment companies, may be questioned on numerous other grounds,[196] have in effect been made to justify a power of management, restrained only by general principles of equity, to dilute the voting and other participating interests of existing stockholders by additional issues of stock. And where common stockholders in a leverage investment company may have been induced to purchase their shares on the basis of "leverage" and have assumed the risks of "leverage" it would seem difficult to justify the withholding of a preemptive right to such stockholders to purchase additional issues of common stock after the company has become successful. Moreover, it is significant that managements holding a Class B "control" stock of a leverage investment company may frequently preserve the preemptive right on further issues of the "control" stock.[197] Certainly this alleged justification can, by its terms, have no application to nonleverage investment companies, the charters of which also frequently eliminate the preemptive right.

It has also been urged that, since the voting power of stocks has become of less importance because of the existence of various devices for control in the management (such as voting trusts, management stocks with special voting privileges, nonvoting common stocks and the management's domination of the proxy machinery), the protection of the stockholders' voting interest against dilution, as the result of additional issues of stock, is of small significance. In other words, the fact that other avenues for diminishing the importance of voting rights exist is thought to constitute a reason to permit a further attenuation of the voting privilege by managements by abolishing the preemptive right. Finally, it is argued that the offering of new shares to stockholders is a cumbersome procedure which may hamper managements when funds must be raised quickly for corporate purposes. However, it may be questioned whether or not this necessity is of greater importance than the interests of stockholders in the preservation of their asset and voting interests in the corporation.[198] Furthermore, these supposed justifications for the

urally leads to the result that the management will have as complete latitude and as little liability as possible; as large a power to arrange and rearrange participations in its own interests as can be secured; and that the prospective shareholder will have as little power and as few enforceable rights as can conveniently be arranged.

[195] See 11 Fletcher, Cyclopedia Corporations (1932), Sec. 5136; Frey, *Shareholders' Preemptive Rights* (1929), 38 Yale Law Journal 563; Drinker, *The Preemptive Right of Shareholders to Subscribe to New Shares* (1930), 43 Harvard Law Review 586.

[196] See the discussion supra, pp. 1624–31.

[197] See Sterling Securities Corporation, discussed supra, pp. 1624–31, and Ch. IV of this part of the report, pp. 1162–78.

[198] Since one of the peculiar characteristics of open-end investment companies, which usually have only one class of stock, is to issue new shares of their stock at their approximate asset values, existing stockholders usually will suffer no dilution in the asset value of their shares, even if no preemptive right exists. However, the new issues of stock may

elimination of the preemptive right give little heed to the economic claims of stockholders, who have originally staked their funds upon the success of an investment company, to a first opportunity to purchase additional securities of the company after it has become successful and its securities offer attractive investment possibilities.[199]

The charters of most investment companies contain provisions eliminating the preemptive right. Of 161 investment companies analyzed only one expressly granted the preemptive right to its stockholders, while 98 companies, a substantial number of which were nonleverage companies, denied to their stockholders any preemptive rights. Five investment companies denied preferred stockholders any preemptive rights and granted common stockholders a preemptive right only when it was proposed to sell new common stock for cash, and 29 companies granted a limited or conditioned preemptive right to one or more classes of stock. The charters of the remaining companies were silent on the subject of preemptive rights so that presumably the common-law rules would apply. It thus may be assumed that in most investment companies today all of the abuses which the common-law preemptive right was designed

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dilute the voting rights, if any, of existing stockholders, a dilution which they will be unable to prevent, since no preemptive right may well exist. In the case of closed-end investment companies, however, the statutes of states having "liberal" corporation laws empower the directors to issue no-par stock, both preferred and common, from time to time for any consideration which they may fix unless in the certificate of incorporation the power to fix the consideration has been reserved to the stockholders (Delaware Revised Code (1935), Ch. 65, Sec. 14). Since the drafting of the charter is in the hands of the sponsors of investment companies it is unlikely that any power to fix the price of new issues of no-par stock will be placed in the stockholders. Thus, in states such as Delaware, managements of investment companies will be enabled to dilute the asset participations of existing stockholders by fixing a price for new shares at an amount less than the asset value of existing shares. Of 161 management investment companies analyzed the charters of 63 give their managements complete discretion in determining the consideration to be received by the corporation on issuance of no-par-value shares. (See also Ripley, Wm. Z., *Main Street and Wall Street,* pp. 38–43.)

[199] Note the following:

> Economically the preemptive right is the legal recognition of the * * * right to invest capital. This right becomes valuable when the enterprise has demonstrated that it will earn a higher rate of return on the capital than the stockholder can get on that capital were he to reinvest it in the open market. Thus if the ruling rate of return on capital is 6 percent and he can invest it in a business which will yield 12 percent, the right to invest capital in the enterprise precisely doubles the useful value of his capital.
>
> Corporations which can continually use additional capital and have demonstrated their ability to earn a high rate of return on it are likely to be constantly seeking additional capital for investment. A notable instance is the American Telephone & Telegraph Co., which calls for roughly two hundred millions of additional capital every two years and is able to earn approximately 12 percent therein. A share of stock in that company, representing a contribution of $100 of capital, will often sell at once for $200 and better, depending on market conditions. The right to subscribe for such a share is thus extremely valuable and is one of the recognized profitable features of that stock. The same factor appears in successful investment trusts (Berle, *Cases and Materials in the Law of Corporation Finance* (1930), pp. 309–10).

Some investment company officials have taken a similar position. Mr. Gayer Dominick, president of National Bond & Share Corporation, testified (Public Examination, National Bond & Share Corporation, at 2199):

> It seems to me that when you offer rights to stockholders that you usually are going to offer those shares of stock at a price which perhaps is a discount under the market. If you have a successful underwriting, it is in the nature almost of an extra dividend to the stockholders if you offer it to them. It is a privilege. It is a way of compensating the stockholder for loyalty to you. It seems to me a perfectly human, proper function to handle it that way.

See also the testimony of Robert E. McConnell, president of Mayflower Associates, Inc., to the effect that as a matter of "common morality" and "good business practice" it is desirable to extend preemptive rights to the stockholders of investment companies (Public Examination, Mayflower Associates, Inc. at 3703).

to protect, such as the power of management by additional issues of stock to convey control to others and to offer to favored persons stock upon terms prejudicial to the asset and voting participation of existing stockholders, are permissible.

Incidents in the history of Sterling Securities Corporation, Aviation Securities Corporation, and General Empire Corporation illustrate the consequences to stockholders which may follow the denial of a preemptive right, whether on common-law principles or by charter provisions.

a. Sterling Securities Corporation

In May of 1929 Sterling Securities Corporation had derived approximately $16,000,000 from the issuance of 500,000 shares of preference stock, 500,000 shares of Class A common stock, and 223,297 shares of Class B common stock. The Class A common stock, which had been sold to the public, had one vote per share and a preference in assets upon liquidation of $12 a share and thereafter to 75% of the remaining assets of the corporation. The charter expressly denied a preemptive right to the Class A common stockholder to purchase further issues of such stock. On the other hand the management of the investment company had purchased all of the Class B common stock, which was a control stock because of its cumulative voting privileges, for a total consideration of $111,648.50. The Class B common stockholders were expressly granted a preemptive right to purchase all subsequent issues of that class of stock, by the investment company's charter.

In May of 1929 the management of Sterling Securities Corporation caused it to issue to Hayden, Stone & Co. 100,000 shares of authorized but unissued Class A common stock at $12 a share and 25,000 shares of Class B common stock at 50 cents a share for prospective services in floating an issue of first preferred stock of the investment company and in procuring the listing of the company's shares on the New York Stock Exchange. The Class A common stock at this time had an asset value of $15 a share and a market value of $25 a share. In other words, the effect of the sale was to dilute the asset participation of the existing Class A common stockholders by $250,000 and to deny to them the opportunity of deriving the profit of $1,300,000 which would accrue to them if they had been given the right to purchase such stock at $12 a share and had immediately resold the same in the market at $25 a share. It was the understanding of the directors that these shares were taken by Hayden, Stone & Co. as a permanent investment. However, Hayden, Stone & Co., within one month after its purchase of the Class A common stock, sold such stock for a profit of $470,000.[200]

This sale of stock by Sterling Securities Corporation to Hayden, Stone & Co. was not without significance from the point of view of the preferred stockholders of Sterling Securities Corporation. In July of 1931 Hayden, Stone & Co. was instrumental in the transfer of control of Sterling Securities Corporation to Atlas Corporation.

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[200] Hayden, Stone & Co. also derived a profit of $101,050 on the sale in 1929 of a portion of its Class B common stock of Sterling Securities Corporation.

Atlas Corporation thereafter purchased or exchanged its shares for the various security issues of Sterling Securities Corporation. These exchanges and purchases by Atlas Corporation involved substantial losses in asset value to the preferred stockholders who sold their stock to Atlas Corporation or exchanged it for Atlas Corporation stock.[201]

b. Aviation Securities Corporation

In January of 1931 Aviation Securities Corporation, a nonleverage investment company, held in its treasury 20,000 shares of its own stock which had been issued and reacquired in the open market. At that time, the asset value of the investment company's stock was $18.62 a share while its market value was $12 a share. Without first offering these 20,000 shares of treasury stock to shareholders [202] they were sold to Atlas Corporation by the board of directors of the company, several of whom had sold to Atlas Corporation, at an attractive price though possessing no immediate value, their personal holdings of option warrants to purchase additional common stock of Aviation Securities Corporation. In fact the purchase of these warrants was apparently made by Atlas Corporation to induce the directors to issue the treasury stock to Atlas Corporation.

The purchase of the treasury stock by Atlas Corporation gave it a 15% voting interest in Aviation Securities Corporation and served as a nucleus for further purchases of the stock in the open market. Ultimately, Atlas Corporation acquired control of Aviation Securities Corporation [203] and, by means of purchases and exchange offers of its own securities, acquired all of the stock of Aviation Securities Corporation for a total consideration in cash and exchanged securities of substantially less than the asset value of such shares.[204]

c. General Empire Corporation

In May of 1931 General Empire Corporation, a nonleverage investment company the charter of which denied any preemptive rights to its stockholders,[205] had outstanding 89,000 shares of capital stock of which 10,000 shares, or 11% of the outstanding stock, were held by Hemphill, Noyes & Co., the sponsors of the investment company. That firm also held option warrants, which then were of no immediate value, to purchase common stock of General Empire Corporation and pursuant to the terms of a stock purchase contract dated July 22, 1929, the firm was entitled to receive additional option war rants to purchase common stock of General Empire Corporation equivalent to one-half of all subsequent issues of stock by General Empire Corporation.

[201] For a detailed discussion of the history of Sterling Securities Corporation, together with citations to the record, see supra, pp. 1624–31, and Ch. IV of this part of the report, pp. 1162–78.

[202] If the treasury stock had been retired instead of being sold to Atlas Corporation, the asset value of the remaining shares of the investment company's capital stock would have been increased by $132,000.

[203] At the time of the sale of the treasury stock, however, the management of Aviation Securities Corporation was unaware of the fact that it was the intention of Atlas Corporation to acquire control of and ultimately to liquidate Aviation Securities Corporation.

[204] For details of Aviation Securities Corporation together with citations to the record, see Ch. IV of this part of the report, pp. 1270–77.

[205] Public Examination, Atlas Corporation, Commission's Exhibit No. 1975.

At this time, Atlas Corporation entered into negotiations for the acquisition of control of General Empire Corporation which was to be accomplished by the issuance by the management, without a first offering to shareholders, of authorized but as yet unissued stock. It was accordingly agreed that a controlling block of this stock of General Empire Corporation was to be issued at asset value for all of the assets of Power and Light Securities Trust, an investment trust 95% owned by Atlas Corporation. Atlas Corporation agreed to purchase the common stock of General Empire Corporation held by Hemphill, Noyes & Co. at its market value and also agreed to purchase for $302,500 the option warrants then held by Hemphill, Noyes & Co. and the warrants which it would receive pursuant to its contract on the issuance of the new stock of General Empire Corporation.

The primary purpose of this arrangement was not to raise additional capital for General Empire Corporation but to transfer control of the investment company to Atlas Corporation. Thereafter Atlas Corporation dissolved General Empire Corporation after acquiring, by cash purchase or exchange offers for Atlas Corporation securities, virtually all of the stock of General Empire Corporation at a substantial discount from the asset value of such shares. Thus, the ultimate purpose of Atlas Corporation was to dissolve General Empire Corporation and to absorb its asset on a profitable basis to Atlas Corporation. Mr. Odlum, the president of Atlas Corporation, testified:[206]

Q. But ordinarily, Mr. Odlum, you don't issue stock to raise capital to immediately liquidate the trust, do you?

A. No, sir; and that wasn't the purpose either.

Q. Well, the ultimate purpose was to liquidate the trust. It wasn't a case where the officers and directors of the General Empire Corporation felt they needed more capital and this was a medium of raising more capital. This is just a device whereby the control of General Empire was transferred—and I am not saying it wasn't in their best judgment. But this transaction was just the mechanics that was used to turn over control of General Empire to Atlas?

A. To turn over the management; yes.

Q. And that was effected without consulting the stockholders of General Empire, isn't that so?

A. I believe so. I was not on that side of the trade.

Thus, as a result of the absence of a preemptive right to purchase the new shares of General Empire Corporation, its existing stockholders were without power to prevent an integral step in the acquisition program of Atlas Corporation.[207]

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[206] Id., at 17903–10.

[207] For a detailed history of the transfer of control of General Empire Corporation to Atlas Corporation and the terms of the exchange offers of Atlas Corporation securities subsequently made for the stock of General Empire Corporation, see Ch. IV of this part of the report, pp. 1258–70. A similar incident occurred in the case of Granger Trading Corporation, a nonleverage investment company whose certificate of incorporation denied a preemptive right to its stockholders. Wallace Groves, through the purchase of a valueless management contract held by the sponsor of Granger Trading Corporation, induced the sponsor to cause Granger Trading Corporation to issue a controlling block of its stock to Yosemite Holding Corporation, an investment company controlled by Mr. Groves. Once in control, Mr. Groves caused Granger Trading Corporation to sell all of its assets to Yosemite Holding Corporation on terms which resulted virtually in a destruction of the entire asset value of the stock of the minority stockholders of Granger Trading Corporation (id., pp. 1302–3).

D. Control Through Voting Trust and Management Agreements

While a form of organization might be adopted for investment trusts and investment companies which would insure complete and continuing control to sponsor interests, various considerations sometimes made it expedient to employ other means of acquiring control without substantial investment. Sponsors may have been dissuaded from employing the Massachusetts or business trust because this type of organization was not generally known outside of the Boston area and frequently did not enjoy legal sanction.[208] Similarly, a public offering of securities carrying little or no voting power might meet with definite sales resistance by the public.

Voting trusts, which when employed were usually created prior to the public distribution of the securities of the investment company, are not unlike the Massachusetts trust form of organization except that the divorcement of ownership and control is even more apparent to investors. As a consequence, voting trusts probably did not have the requisite sales appeal and were seldom employed in investment companies. Management agreements, on the other hand, have proven a simple and less obvious device of control, frequently employed in combination with other control devices but adequate of themselves to thwart management opposition.

1. VOTING TRUST AGREEMENTS

A voting trust agreement is an agreement which assembles in the hands of a person or group of persons the shares of several owners of stock, in trust giving the trustee or trustees the power of voting them and thereby of controlling corporate business and affairs. The agreement ordinarily confers upon the voting trustees the right to vote the stock transferred to them for such purpose irrevocably and for a definite period. The voting stock, itself, is transferred to the trustees who issue voting trust certificates to the stockholders as evidence of their beneficial ownership of the stock.

The avowed purpose of the voting trust is to disfranchise the stockholders. The pecuniary incidents of stock ownership, such as cash dividends and rights on dissolution, are usually reserved to the certificate holders by the voting trust.[209] Although originally held illegal by the courts,[210] voting trusts have in a number of states been legalized

[208] Perhaps because of the absence of governmental supervision of the organization and activities of business trusts, some courts have exhibited a marked tendency to hold such trusts to be limited partnerships and therefore violative of statutes which forbid partnerships consisting solely of partners who have only a limited liability for the partnership debts (see *Thompson* v. *Schmitt,* 115 Tex. 53, 274 S. W. 554 [1925]) or to find such trusts "illegal" as being, in effect, corporations which have not been validly chartered in accordance with State law. (See *Weber Engine Co.* v. *Alter,* 120 Kan. 557, 245 Pac. 143 [1926]; see also supra, pp. 1888–91.)

[209] Thus, the voting trust agreements which existed for the voting stock of 9 investment companies (out of 150 companies examined) between 1927 and 1935 all provided that cash dividends were to be received by the certificate holders. However, stock dividends having voting power were reserved to the voting trustees in 8 out of 9 cases so as to prevent a possible dilution of the voting power in the voting trust.

[210] See Berle and Means, *The Modern Corporation and Private Property* (1935), pp. 77–8. The attitude of the courts may be gleaned from the following statement in the *Shepaug Voting Trust cases,* 60 Conn. 553, 24 Atl. 32 (1890):

> It is the policy of our law that ownership of stock shall control the property and the management of the corporation and this cannot be accomplished, and this good policy

by statute. These statutes, however, usually limit the duration of voting trusts to a period of 10 years, in one instance permitting renewal of the trust for an additional 10 years.[211]

The voting trust offers to promoters the opportunity for autocratic control without any personal investment. It thus constitutes a means by which the sponsors of investment companies may allocate to themselves all the emoluments of control such as salaries, management fees, underwriting, and brokerage business and other advantages without any financial loss if their management of the company is unsuccessful. The voting trust agreement usually is prepared by the organizers of the corporation prior to any public offering of its securities and all of the voting stock may be deposited with the voting trustees so that the public is offered only voting trust certificates.[212] By this means, the selection of the personnel of the voting trustees and the scope and latitude of the powers placed in voting trustees usually is vested in the corporate promoters. This method is obviously more effective than the formation of voting trusts after the stock has been distributed to the public since it avoids the difficulties of persuading a widely scattered group of stockholders to deposit their shares with the trustees.

The sponsoring group having selected the initial trustees, the voting trust agreement usually empowers such trustees to fill vacancies in their membership. For example, in only one voting trust agreement of an investment company coming to the attention of this Commission were the stockholders empowered to elect the successors of resigning trustees.[213]

In addition to the power of the voting trustee to elect directors and officers and to appoint managers in the case of investment companies, they normally have the power to vote for sales of the entire corporate assets, for mergers and consolidations with other corporations, to effect reductions of capital and other corporate activities of vital con-

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is defeated, if stockholders are permitted to surrender all their discretion and will in the important matter of voting and suffer themselves to be mere passive instruments in the hands of some agent, who has no interest in the stock, equitable or legal, and no interest in the general prosperity of the corporation. In addition there is— the duty that one stockholder in a corporation owes to his fellow stockholder and he cannot be allowed to disburden himself of it in this way. He may shirk it, perhaps, by refusing to attend stockholders' meetings or by declining to vote when called upon but the law will not allow him to strip himself of the power to perform his duty and to this extent, at least, a stockholder stands in a fiduciary relation to his fellow stockholders.

Some courts influenced by the management's power to continue in control in any event because of the wide geographical dispersion of small stockholders and the management's control of the proxy machinery have held that the importance of the vote has diminished to such an extent in modern corporations that voting trusts may be justified. See *Mackin* v. *Nicollet Hotel*, 25 F. (2d) 783 (C. C. A. 8th, 1928), cert. den. 278 U. S. 618. However, in the absence of a voting trust the power is latent in the stockholders to discharge an unsatisfactory management. This power would not exist in the case of holders of voting trust certificates.

[211] E. g., Delaware Revised Code (1935) Chapter 65, Section 18. A voting trust created for a period in excess of that prescribed by this statute is wholly invalid and is not merely void as to the period of time beyond that prescribed by the statute (*Perry* v. *Missouri-Kansas Pipe Line Co.*, 191 Atl. 823 [Del. Ch. 1937]).

[212] In 8 of the 9 investment companies (out of 150 companies examined) which possessed voting trusts in their voting stocks between 1927 and 1935, the voting trust was created prior to the financing of the investment company and the public was offered only voting trust certificates. In all the 9 cases the trusts were revocable during the period of their existence only by the trustees.

[213] Reply to the Commission's questionnaire for American Electric Securities Corporation, Pt. I.

sequence to shareholders.[214] The voting trustees have the power in the case of investment companies without the concurrence of, or even the necessity of informing the certificate holders, to change radically the announced investment policies of the corporation. It may be doubted that voting trust certificate holders read or are fully aware of the scope of the usual provisions of voting trust agreements which they are in law presumed to accept by purchasing a voting trust certificate.

Despite the broad powers of voting trustees over their controlled investment company, the voting trust agreements contain provisions designed to relieve them from any responsibility. In many cases the voting trustees are expressly empowered to deal freely with the investment company and its assets and usually are exculpated from all liability except for willful malfeasance.[215]

The sponsors of Incorporated Investors, organized under the laws of Massachusetts on November 23, 1925, were among the first to employ the device of the voting trust with reference to the stock of an investment company. In this case the voting shares were deposited with the voting trust from the very beginning and only voting trust certificates were offered to the public.[216] Such certificates were sold to December 31, 1936, for an estimated total of $103,261,000 at which date the investment company possessed assets of $77,000,000.[217] The control of such considerable funds was thereby vested in a few individuals who were not required to make any substantial investment in the enterprise and who were absolved under the voting trust agreement from the consequences of their acts and omissions except for their "willful malfeasance."[218] The sponsors, who were the voting trustees and the officers and directors of the investment company, allotted to themselves contracts for management and distribution services and derived total net profits from their affiliation of some $1,900,000 to December 31, 1935.[219]

The desirability of such an unrestrained control of the highly liquid and easily negotiable assets of investment companies may be questioned. It is significant that in some jurisdictions voting trusts of the stock of analogous financial institutions such as banking corporations, are forbidden or regulated by statute.[220] The common justifica-

[214] Of the 9 investment companies (out of 150 companies examined) possessing voting trust agreements between 1927 and 1935, only 3 required the concurrence of the certificate holders in connection with a proposed reorganization, merger, consolidation, recapitalization, dissolution, or sale of the assets of the investment company. Of the 3 agreements, 2 required the vote of a majority of the certificate holders to validate any of these procedures and 1 required the vote of two-thirds of the certificate holders.

[215] This was true in all 9 investment companies (out of 150 investment companies examined) possessing voting trust agreements at some time during the 1927–1935 period. Three of the agreements further stated that the voting trustees were to be indemnified against all losses and liabilities sustained under the respective agreements. Requirements with respect to the financial responsibility of the voting trustees have generally not been provided. In fact, the voting trust agreement of 1 of these 9 investment companies expressly provided that under no conditions were the trustees to be required to furnish a bond for the faithful performance of their duties.

[216] Public Examination, Incorporated Investors, at 2547–8 and 2695–6, and reply to Commission's questionnaire for Incorporated Investors, Pt. I.

[217] Derived from supplementary information supplied the Commission for Incorporated Investors.

[218] Public Examination, Incorporated Investors, at 2688–9 and Commission's Exhibit No. 294.

[219] Id., at 2532, and Commission's Exhibits Nos. 295, 296, 297. These contracts were signed on behalf of both parties by various of the said interested sponsors (ibid.).

[220] E. g., New York Stock Corporation Law, Sec. 50.

tion of voting trusts is that it assures a continuity of management to the enterprise. However, as has been stated, most voting trusts make it possible for the trustees to resign seriatim and for the remaining trustees to elect their successors. That this power in the voting trustees to surrender their trust may be of serious consequence to the disfranchised stockholders is illustrated by the case of Universal Shares, Ltd.

a. Universal Shares, Ltd.

In June of 1936 Universal Shares, Ltd., a company which had been organized in Delaware in 1933 for the purpose of owning and controlling various investment trusts and companies, held all of the common stocks of United Sponsors, Inc., and of United Standard Oilshares Corporation. These latter companies, by virtue of management and distribution contracts, held effective control of Investors Fund of America, Inc., and of United Standard Oilfund of America, Inc., both of which were management investment companies. The total assets of these two investment companies totaled approximately $3,200,000.[221]

Universal Shares, Ltd. had outstanding 481,433 shares of 10 cents par value capital stock at June 10, 1936. A majority, or 251,400 of these shares, were held in a voting trust of which Gen. John F. O'Ryan, Murray Spies, and Lucian A. Eddy were voting trustees. The voting trust at this time had approximately eight years to run and apparently the trustees were empowered to appoint their successors in the event of their resignation. Mr. Spies held none of the shares of Universal Shares, Ltd., or its subsidiaries. The record does not indicate the holdings, if any, of Mr. Eddy or Gen. O'Ryan. Harold A. Espey, one of the organizers of Universal Shares, Ltd., held 127,500 of the outstanding voting trust certificates. Messrs. Spies, Eddy, and Espey and Gen. O'Ryan were directors and officers of Universal Shares, Ltd., and its subsidiaries. Mr. Eddy was also president of both Investors Fund of America, Inc. and United Standard Oilfund of America, Inc.

On May 8, 1936 Donald P. Kenyon, who was then actively engaged in purchasing control of investment companies with the purpose of converting their funds to his own use, acquired for the sum of $20,000 all of Mr. Espey's holdings of the voting trust certificates of Universal Shares, Ltd. Mr. Espey agreed to sever his connections with Universal Shares, Ltd., and to use his best efforts to obtain the resignation of the voting trustees. Since the asset value of Mr. Espey's stock did not exceed $12,750, Mr. Espey received from Mr. Kenyon approximately $7,000 in excess of the actual value of the shares.

Mr. Kenyon himself, in June 1936, approached the voting trustees who were, by virtue of the voting trust, in actual control of the Universal Shares group of companies, in an effort to secure their resignations. The first of the voting trustees approached by Mr. Kenyon was Gen. O'Ryan, who was induced by Mr. Kenyon to resign as a voting trustee.

On June 10, 1936, Mr. Kenyon reached an agreement with Murray Spies. Mr. Spies agreed that he would resign as a voting trustee, that

[221] For full details and documentation see Ch. II, pp. 309–49, and Ch. IV, of this part of the report, pp. 1316–23.

he also would secure the resignation of Mr. Eddy as a voting trustee, and that he would secure the appointment of Mr. Kenyon and his nominees as voting trustees. Mr. Spies further agreed to resign as an officer and director of Universal Shares, Ltd., and its subsidiaries. In return for these undertakings on the part of Mr. Spies, Mr. Kenyon agreed to pay Mr. Spies $40,000, of which Mr. Spies paid Mr. Eddy $2,000. Mr. Eddy testified that the payment of $40,000 was made to reimburse Mr. Spies and Mr. Eddy for back salary, legal fees, and other unpaid claims which they held against Universal Shares, Ltd., and its subsidiaries. Nevertheless, the agreement between Mr. Spies and Mr. Kenyon indicates that the payment of $40,000 was intended, in part at least, to compensate Mr. Spies for his future acquiescence in the plans of Mr. Kenyon. The agreement provided further that Mr. Spies would not interfere with Mr. Kenyon's acts in his operations of Universal Shares, Ltd., and its subsidiaries and that he would not represent stockholders of any of the companies in any action against Mr. Kenyon.

Thus, for a pecuniary consideration, Mr. Spies and Mr. Eddy, who owned few, if any, of the shares of Universal Shares, Ltd. and its subsidiary investment companies, turned over the voting trust and management control of these companies to Mr. Kenyon. Stockholders, who held the real stake in these enterprises, were never consulted or informed of the passage of control of their companies to Mr. Kenyon until after the event. In addition, Mr. Spies vacated his position as a fiduciary of the stockholders under an agreement not to oppose any of Mr. Kenyon's future acts.

Between June and November of 1936, when their activities became the subject of state and federal investigations, Mr. Kenyon and his associates succeeded in converting to their own uses in excess of $400,000 of the funds and assets of Universal Shares, Ltd. and its subsidiaries.[222]

b. Bankers Securities Corporation

Voting trust agreements were favorite control devices with the sponsor of Bankers Securities Corporation, which was organized on April 3, 1928, in the State of Pennsylvania under the sponsorship of Bankers Trust Company of Philadelphia.[223] The capital structure of Bankers Securities Corporation consisted of one class of common stock, having the entire voting rights, and one class of preferred stock, for both of which stocks it received an aggregate net capital of $24,000,000.[224] The announced purpose of this enterprise was to serve as a regular securities affiliate of the bank but it operated largely as an investment company.[225] The promoter and moving spirit of both the bank and Bankers Securities Corporation was Albert M. Greenfield, of Philadelphia, Pennsylvania.

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[222] Donald P. Kenyon died on December 27, 1938. On November 22, 1939, various associates of Mr. Kenyon and others were convicted in the United States District Court for the Southern District of New York, as participants in a conspiracy involving the use of the mails to defraud Universal Shares, Ltd., and its affiliated companies. (See Ch. II of this part of the report, pp. 309–49.)

[223] Reply to the Commission's questionnaire for Bankers Securities Corporation, Pt. I.

[224] Id., Pts. I and II.

[225] Op. cit. supra, note 223, Pts. I and III.

The Bankers Trust Company of Philadelphia and the Bankers Securities Corporation became pivotal units in an involved chain of corporations, the details of which are not pertinent here. At one time or another during the period from 1928 to 1935, inclusive, there were five separate voting trust agreements operating in connection with the various units in this system, of each of which trusts Mr. Greenfield was one of the voting trustees. Two of these voting trusts controlled the Bankers Securities Corporation, one applied to the stock of the City Stores Company,[226] the largest subsidiary of Bankers Securities Corporation, and two voting trusts controlled two of the other corporations in the system.[227] Particular reference is made to the voting trusts which controlled Bankers Securities Corporation.

On January 2, 1929, a voting trust of the common stock of Bankers Securities Corporation was set up with the Bankers Trust Company, Mr. Greenfield, and William Fox as the voting trustees.[228] This trust was limited to the 15,375 shares of common stock and 30,750 shares of preferred stock which the bank owned and which it wished to offer to its shareholders without surrendering the 25% voting power this common stock represented. The accomplishment of this maneuver realized for the bank a profit of $1,383,750, on an investment made but a few weeks before, without loss of the voting power.[229] This agreement ran for five years to January 2, 1934, and was subject to automatic renewal for another five years to January 2, 1939.[230]

On October 1, 1932, another voting trust was created with Mr. Greenfield as the sole trustee. This agreement, which operated concurrently with the first agreement, ran for five years to October 1, 1937, and was subject to automatic renewal for another five years to October 1, 1942.[231] The purpose of this agreement was to bring a greater number of common shares under the control of the management group. All other shareholders were therefore invited to place their shares under this voting trust and at the end of 1935, 23,275 shares or 38.8% of the voting stock of Bankers Securities Corporation had been so deposited. By these two trusts approximately 65.9% of the voting stock of Bankers Securities Corporation came under control of the management group.[232]

By virtue of the fact that the Bankers Trust Company resigned as voting trustee after its failure in December 1930 and Mr. Fox became practically inactive, Mr. Greenfield personally controlled Bankers Securities Corporation through the two voting trusts.[233]

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[226] Derived from supplementary information supplied the Commission for Bankers Securities Corporation.

[227] Ibid. These latter two affiliated companies were Albert M. Greenfield & Co. and Union Building Company.

[228] Ibid.

[229] Ibid. From this profit may be deducted any premium over $60 a share paid in acquiring the preferred stock and $125,000 paid to an underwriting syndicate organized by Mr. Greenfield and Mr. Fox (ibid.).

[230] Op. cit. supra, note 223, Pt. I.

[231] Ibid.

[232] Id., Pt. V. A total of 60,000 common shares were outstanding at December 31, 1935 (id., Pt. I).

[233] Op. cit. supra, note 226. At the end of 1935 Mr. Greenfield personally owned 8,383 shares of preferred stock and 5,049 shares of common stock (op. cit. supra, note 223, Pt. V).

2. MANAGEMENT CONTRACTS

The management contract is a device of control which is particularly applicable to investment companies. Investment companies have generally been represented as essentially vehicles for the management of the funds of the public by those who hold themselves out as skilled in investment. Usually, the management of a corporation is vested in its directors and officers who are elected annually by its stockholders or their representatives. In the case of investment companies, however, the power of management conferred on the officers and directors by the stockholders, in a great many instances, has been "delegated" by the directors and officers to other individuals or corporations (which may include other investment companies) under agreements by which such individuals or corporations are vested either with power to invest and reinvest the funds of the investment company or with power to suggest investments subject to the approval of the board of directors or to the representative body of the shareholders.[234] However, the sponsors, who usually acted as managers, customarily selected the members for the board of directors so that disapproval of the investment suggestions would be unlikely.[235] In the instances where the managers were selected by the directors presumably on the basis of expertness, it is also unlikely that the directors would disapprove the managers' suggestions.

In practice, the individuals holding management contracts have a dominating influence over the assets and investment policies of an investment company so long as the contract endures. Action by the corporation or stockholders to terminate the contract before the contractual date of its termination, in the absence of nonperformance or willful malfeasance upon the part of the holders of the contract, may require the payment of damages to such holder. These damages, in the case of a long-term contract, may be very substantial and place an undue burden upon the corporation. In other words, it is difficult to displace the holder of a management contract even if the performance of the investment company has been unsuccess-

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[234] The abdication of the directors' function may be of doubtful validity. See *West v. Camden* (1890), 135 U. S. 507; *Sherman & Ellis v. Indiana Mutual Casualty Co.*, 41 F. (2d) 588 (C. C. A. 7th, 1930). In the *Sherman & Ellis* case, supra, the board of directors of a casualty insurance company agreed to permit a management company to manage the affairs of the casualty company for a period of 20 years and to appoint the underwriting manager and "executive head" of the casualty company. The court held the contract unenforceable as against public policy, stating:

> If there existed a conflict of opinion between the board and appellant [the management company] whose voice under this contract would control? Obviously appellant's. The length of time during which the agreement was to operate likewise indicated that not only managerial powers were delegated, but the entire policy of the casualty company's business was to be fixed and determined by appellant. No other conclusion can be drawn from this agreement and the evidence than that the casualty company was to be merely an instrumentality through which appellant was to conduct a general casualty insurance business in the state of Indiana. The agreement which accomplished this result transcends the spirit and theory upon which corporate franchises are based and is void.

[235] For example, the sponsor of Oils & Industries, Inc., who obtained a management contract for 10 years at the inception of the company, also selected the company's entire board of directors. (See Ch. II of this part of the report, pp. 94–115.)

ful.[236] The control of the management contract holder can be further strengthened by provisions in the contract empowering the manager to nominate several or all of the directors and officers of the investment company,[237] or requiring approval by the manager of the directors elected by the stockholders.[238]

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[236] Thus, Walter F. Stafford, a former president of Iroquois Share Corporation, testified (Public Examination, Iroquois Share Corporation, at 14027–8):

> Q. Now you can see, Mr. Stafford, how vital the problem of management contracts on the part of the stockholder was, because if the sponsors organized the trust and gave themselves a fifteen or twenty year contract; it means that the stockholders couldn't dispose of the investment trust unless they took care of the sponsors, isn't that so?
> A. That is so.
> Q. And that would be true even if the sponsors * * * didn't invest a nickel in the investment trust, isn't that so?
> A. If they had the contract, absolutely.
> Q. And the usual situation was that the sponsors gave themselves the contract before the public distribution of the securities took place, isn't that so?
> A. Well now, I can't speak for the other trusts.
> Q. But that is what happened here, isn't it?
> A. That is so.
> Q. Well, do you know what particular harm would be done to the investors if provision was made that no management contracts should last more than a year and that the renewals should be subject to the approval of stockholders? In this particular case [Iroquois Share Corporation] Mr. Stafford no matter what your performance was as long as you were honest the stockholders would have to keep you there, isn't that so?
> A. Yes.

The difficulties confronting stockholders who may attempt to eliminate the holders of a management contract were described as follows by Joseph Meyer, Jr., who with another individual controlled Petroleum Research Corporation which held a 10-year management contract with Oils & Industries, Inc. (Public Examination, Oils & Industries, Inc., at 14147–8):

> Q. No person was going to make a substantial investment in that situation [Oils & Industries, Inc.] with a management contract outstanding whereby you [the management] were going to get payments and participate in the earning of the trust, isn't that so?
> A. Oh, probably not.
> Q. Isn't that right?
> A. Of course, that depends upon the temper of the group.
> Q. So that at least in any negotiations which looked to extrication of the stockholders from their predicament involving a change in management, your management contracts at least was an impediment to that transfer of control or change in management.
> A. Certainly any group would have to give it serious consideration.
> Q. That is right and this management contract was signed, in force and effect before the units were sold to the public. Now you said to the stockholders "you will take it this way or you can't come in"?
> A. Yes; correct.
> Q. But if you did come in, and if the situation did arise where it was to the best interests of stockholders that there be a change of management, they could do nothing about it if the new interests desired to oust the Petroleum Research Corporation unless the new interests took care of the Petroleum Research Corporation, isn't that so?
> A. Still, of course, it is like any other contract. If the service was not performed, they could sue for cancellation.

For a detailed history of Oils & Industries, Inc., and the consequences to its stockholders of the sale of the management contract held by its sponsors to an irresponsible group of individuals, see Ch. II, pp. 94–115, and Ch. IV of this part of the report, pp. 1293–5.

[237] See the contract between J. & W. Seligman & Co. and Tri-Continental Corporation, discussed infra, pp. 1927–32. The management contract between the brokerage firm of Dominick & Dominick and National Bond & Share Corporation provided: "It is contemplated that the Board of Directors of the Corporation will consist only of partners (general and special) in the firm (Dominick & Dominick) and that its officers may be, in whole or in part, members or employees of the firm" (Reply to the Commission's questionnaire for National Bond & Share Corporation, Pt. I). A similar provision was contained in the management contract which existed from 1928 to 1933 between Goldman, Sachs & Co. and The Goldman Sachs Trading Corporation (Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1654).

[238] For example, an examination of the replies to the Commission's questionnaire for 205 management investment companies (Pt. I) revealed that provisions empowering the management contract holder to terminate the contract if a director is elected wihout his

Moreover, from the viewpoint of the sponsors of investment companies, the management contract may be more advantageous than other control devices. Like voting trusts, management contracts can create control without the necessity for any financial stake in the enterprise by the managers and serve as a means of discouraging others who might attempt to acquire sufficient voting stock to depose sponsors who have little or no stock interest in the investment company.[239] Management contracts not only can create control without the necessity for investment in the enterprise but may even insure revenue to the holder of the contract irrespective of the performance of the investment company. Furthermore, the management contract form of control avoids the necessity for offering to the public non-voting stocks or voting trust certificates which, in view of the obvious disfranchisement involved, may be difficult to sell. In addition, the period of duration and right of renewal of such contracts, are not at present regulated by statute. Finally, the standard of conduct required of the holder of the management contract can, by provisions in the contract, be set at a lower level than that which would be required by the courts of managing directors.[240]

These contracts are usually drafted and accepted by the sponsors themselves, or by directors of their own choosing, at the inception of the investment company and prior to the issuance of the company's securities to the public. In other words, the contracts are obtained in a self-dealing transaction in which no one represents the prospective shareholders of the investment company. In fact, the existence of a management contract was often not revealed to the stockholders in the prospectus offering the investment company's securities to the public or in its periodic reports to stockholders.[241]

Of 205 management investment companies analyzed, 105 had entered into management contracts at some time during the period 1927–1935 and at December 31, 1935, management contracts existed for 68 of such investment companies. These management contracts

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approval appeared in seven of 68 management contracts in existence at December 31, 1935. The contract between Goldman, Sachs & Co. and The Goldman Sachs Trading Corporation which was terminated in 1933 also contained such a provision (Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1654).

[239] See discussion of Tri-Continental Corporation, infra, pp. 1927–31.

[240] Thus, directors of a corporation, as fiduciaries of the stockholders, are liable to the stockholders for negligence. See *Hun* v. *Cary* (1880), 82 N. Y. 65, 37 Am. Rep. 546; *Kavanaugh* v. *Gould,* 223 N. Y. 103, 119 N. E. 237 (1918); *O'Connor* v. *First National Investors Corporation,* 163 Va. 908, 177 S. E. 852 (1935). However, those who stand in a contractual relationship with corporations, such as the holders of management contracts, although they are liable as fiduciaries for wilful mishandling of the corporate assets (Cf. *Field* v. *Western Life Indemnity Co.,* 166 Fed. 607 [N. D. Ill. 1908] aff'd sub. nom. *Moulton* v. *Field,* 179 Fed. 673 [C. C. A. 7th (1910)]) may be permitted by the courts to insert provisions in their agreements absolving them from liability for their negligence. See *Hazzard* v. *Chase National Bank,* 159 Misc. 57, 287 N. Y. Supp. 541 (1936); *Green* v. *Title Guarantee & Trust Company,* 223 App. Div. 12, 227 N. Y. Supp. 252 (1928); *Restatement of the Law of Trusts* (American Law Institute 1935), Sec. 174 (d); 222. However, it can be argued that the confidence placed in the holders of management contracts by stockholders and their absolute control of the management of the corporate assets may result in a refusal by the courts to permit such individuals to contract for a lesser standard of liability than would be imposed on managing directors.

[241] Of 68 investment companies which possessed management contracts at December 31, 1935, 22 companies reported that their management contracts had never been formally revealed to the stockholders in prospectuses or annual reports. Compare the case of Federated Capital Corporation discussed infra, pp. 1934–6.

provided for a variety of management powers, duties, services, and accommodations. However, contractual limitations with reference to the services to be performed by the managers were at times minimized by the fact that persons ostensibly employed to provide advisory investment services have used loosely phrased provisions as bases upon which to assume all of the management functions. This was particularly true where the persons providing management also served as officers and directors, by reason of the difficulty of segregating their functions.[242]

Of primary importance from the point of view of the control afforded by management contracts, are the provisions relating to their duration, renewal, and termination. Obviously, the longer the duration of such contracts the more secure will be the control acquired by the holders of such contracts. Management contracts of 43 out of 68 investment companies at December 31, 1935, possessed specified periods of duration varying from one to 20 years, the usual provision being 10 years. The average duration of all of the contracts was six years and five months. Moreover, contracts of 27 of these 43 investment companies provided for automatic renewal at the dates of their termination. Of these 27 contracts, 15 were automatically renewable for five-year periods and 12 were renewable from year to year. The seven investment companies in this group which in form of organization were Massachusetts or business trusts possessed management contracts which endured for the lives of the trusts.[243]

Termination provisions appeared in 60 of the 68 management contracts in existence at December 31, 1935. Of these 60 contracts, 20 provided that the company or its stockholders had no privilege to terminate at any time before the prescribed duration of such contracts or before the renewal dates thereof. And of these 20 management contracts, six required, in addition to the assent of directors, the approval of the stockholders to prevent the automatic renewal of the contract on the specified date of its expiration. Of the 40 management contracts which provided a method of termination by the investment company prior to the contractual date of expiration, eight required the concurrence of a majority or more of the stockholders. Although the remaining 32 contracts required only the vote of the directors for a termination of the contract at any time, such provisions may not have been of particular effectiveness to the investment company since quite commonly the holder of the management contract had played an important part in the selection of the directors. Contract provisions permitting a prescribed number of stockholders to terminate the management contract normally would be of little practical value to stockholders seeking to depose

[242] Three investment companies with management contracts at December 31, 1935, possessed assistant managers, while the managers of three other investment companies also acted as depositaries. None of the 68 contracts in effect at December 31, 1935, called for the exclusive services of the managers, while three managers were expressly permitted to provide like services to others. Only 21 management contracts contained a provision as to retention of control of management by the board of directors, and only 16 gave directors authority to require reports on the affairs of the investment company being managed.

[243] Usually the indenture creating the Massachusetts or business trust form of investment company provided that the trust was to endure for the lives of the trustees and 21 years thereafter.

the holder of the management contract. Ordinarily only a comparatively wealthy stockholder would be able to afford to organize and obtain the vote of the required number of stockholders for the termination of the contract.[244]

The compensation to the managers provided for in the management contracts usually was fixed to produce revenue to such managers irrespective of the success or nonsuccess of their management. The majority of management contracts provided for fixed compensation irrespective of performance. Usually, brokers who held management contracts received the brokerage business of the investment company in addition to the prescribed fee for management. A stated percentage of the assets of the investment company, normally one-half of 1%, was ordinarily fixed as the annual compensation for management. In some cases a percentage of earnings was the basis of compensation, while other contracts provided for a fixed sum as compensation.[245] Of the 68 investment companies having management contracts in existence at December 31, 1935, 37 computed compensation on a percentage of assets, 11 computed compensation on a percentage of earnings ranging from 6% to 25% of earnings and averaging 13½% of earnings, while 9 fixed a stated sum, usually in the neighborhood of $20,000 a year, as compensation. The definition of "assets" rested largely with the sponsors who drafted the management contracts. In one case [246] assets was defined to include borrowed funds so that the manager had an incentive not only to increase "assets" by borrowing but also to speculate with borrowed funds in the hope of increasing "assets."

In two cases as at December 31, 1935, management was compensated solely by the issuance of option warrants to purchase the common stock of the investment companies involved.[247] The desirability of this method of management compensation may be ques-

[244] For example, from 1928 to April 1933, Goldman, Sachs & Co., which held only 4% of the voting stock of The Goldman Sachs Trading Corporation, was in control of that corporation by virtue of a management contract under the terms of which all of the partners of the firm had become directors of the investment company and which also empowered the firm to resign as manager if it did not approve of directors by the stockholders. The management contract provided that it could be terminated at any time on the vote of a majority of the investment company's stockholders. From 1929 to 1933 the assets of The Goldman Sachs Trading Corporation declined from a market value of approximately $326,000,000 in 1929 to approximately $32,000,000 in 1933. Despite the performance of the company in this period, no stockholders made any organized attempt to terminate the management of the company by Goldman, Sachs & Co. However, by April 1933, Atlas Corporation had acquired in the market and from large holders 40% of the voting stock of The Goldman Sachs Trading Corporation and possessed the financial means to continue its purchases until it had acquired a majority of such stock. In April of 1933, Goldman, Sachs & Co. agreed to terminate their management contract and to turn over the management of The Goldman Sachs Trading Corporation to Atlas Corporation as the holder of the largest single block of the stock of The Goldman Sachs Trading Corporation. At a stockholders' meeting held in April 1933, the resignation of Goldman, Sachs & Co. as managers of The Goldman Sachs Trading Corporation and the election of nominees of Atlas Corporation to the board of directors of The Goldman Sachs Trading Corporation was approved (Public Examination, Atlas Corporation, Commission's Exhibit No. 2001).

[245] Of the 105 investment companies possessing management contracts at some time during the 1927–1935 period, 46 computed compensation as a percentage of assets, 17 computed compensation as a percentage of earnings, and 13 employed a stated sum.

[246] Federated Capital Corporation. See Ch. IV of this part of the report, pp. 1278–1303.

[247] Of the 105 management contracts in existence for investment companies at some time from 1927 to 1935, 6 provided for compensation in the form of option warrants.

tioned. In the first place, option warrants in themselves are a device for control,[248] and if the company were unsuccessful, the warrants were salable to others who desired control for purposes perhaps inimical to the interests of stockholders.[249] Second, the tendency will be for the manager to "watch the market" in the stock of the investment company and to sell his warrants as early as possible at a profit.[250] The result may be that the investment company will be managed by individuals with no further pecuniary interest in its success.[251] Third, the exercise of the warrants might involve a dilution of the equity of the stockholders to an extent which cannot be estimated at the date of the contract. As a consequence the exact amount of compensation which their managers might derive at their expense cannot be accurately forecast by the stockholders and, being

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[248] See supra, pp. 1895–9.

[249] For instances of the purchase of warrants by individuals or corporations who desired control for reasons possibly opposed to the interests of stockholders, see Ch. IV of this part of the report.

[250] Public Examination, Yosemite Holding Corporation, at 1436.

[251] For example, Hayden, Stone & Co. and Hallgarten & Co., on the formation of Haygart Corporation in 1929, received option warrants as advance and permanent compensation for their management of the investment company. Within a year the sponsors sold their options for a profit of $2,800,000, and at the close of approximately one year of operation of the investment company caused it to be merged with The Adams Express Company (Public Examination, The Adams Express Company, at 6878–84, 6912–3 and Commission's Exhibit No. 638). Thus, as testified by Steele Mitchell, of Hayden, Stone & Co., the management of Haygart Corporation had received a large profit before "the actual work had been done" (id., at 6924–5). Similarly, the original sponsors of Chain Store Stocks, Inc., E. Naumberg & Co., F. S. Smithers & Co., and Shields & Co. received option warrants as permanent compensation for management. Within a year, E. Naumberg & Co. and F. S. Smithers & Co., who had sold the securities of Chain Store Stocks, Inc., to their customers, who presumably relied upon the permanence of connection of these firms with the management of the corporation, sold their option warrants to Shields & Co. at a profit of $300,000 and severed their connections with the corporation. Paul V. Shields, of Shields & Co., testified with respect to the propriety of warrants as management compensation (Public Examination, Chain Store Stocks, Inc., at 15614, et seq.):

> Q. The option warrants were to constitute compensation to the management. There was no management agreement?
>
> * * * * * * *
>
> A. That is right.
>
> Q. Now the option warrant to purchase stock at the issue price for a period of five years has a fairly substantial value. A warrant like that is worth anywhere from $5 to $10 if there is any success in the company; isn't that right?
>
> A. That is what we hoped.
>
> Q. Now just one thought about that, Mr. Shields; there was no formal agreement requiring the sponsor * * * to retain their warrants as long as they were with the investment trust, was there?
>
> A. No; there was no agreement.
>
> Q. So that there was no legal * * *.
>
> A. That is right, no written agreement. There was a definite understanding, naturally, that that was compensation for their contribution to the management.
>
> Q. But there was no legal disability or contractual disability on the part of any of these sponsors from taking and selling their warrants the very next day.
>
> A. No; that is right.
>
> Q. So that the situation was that the compensation which was supposed to cover the management's services rendered throughout at least the entire period these people were to be associated with the investment trust could have been disposed of the following day.
>
> A. That is right.
>
> Q. Which would have left the investment trust in this position: that these people had received their full compensation from the management the next day by selling the warrants and therefore they would have no pecuniary interest in the success or management of the investment trust; isn't that so?
>
> A. That is right.
>
> * * * * * * *
>
> Q. * * * Do you think, looking back in retrospect, Mr. Shields, that that is the best way of compensating management of an investment trust, namely, through the issuance of option warrants and management stock?
>
> A. No; it was fashionable then, that was a sort of smart thing to do, but as it works out there is no question it is not the sound thing to do.

dependent upon market quotations, may far outstrip asset value as a measure of performance.[252]

Responsibilities commensurate with the control and emoluments which are derived by management contracts were rarely assumed by the holders of such contracts. Provisions exculpating the management contract holder from all liability to the corporation and its stockholders other than for wilful malfeasance or bad faith appeared in 22 of the 68 management contracts in existence at the end of 1935.[253] Further, provisions in the management contracts frequently permitted the managers to deal personally as principals with the investment companies by purchasing from or selling securities to the investment companies. Of the 68 management contracts in existence at the end of 1935, 11 contained such provisions. Usually the contract provided that the manager was permitted to deal with the investment company without any accountability whatsoever to stockholders for profits or losses resulting from such transaction if such transaction was "reasonable" and considered fair by the directors.[254] In the frequent cases where the directors had been selected by the management contract holder or were otherwise friendly to him, no independent judgment as

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[252] On this aspect of management compensation by means of option warrants, Paul V. Shields, a director of Chain Store Stocks, Inc., which issued option warrants as compensation to management, testified (Public Examination, Chain Store Stocks, Inc., at 15618, et seq.) :

> Q. Suppose the trust is very successful and the asset value of the stock approached \$50 to \$100. Then the sponsor by exercising their option warrants would only have to contribute \$37.50 [the exercise price of the warrants of Chain Store Stocks, Inc., held by its managers] and immediately their stock was worth one-third of the difference between \$37.50 and \$100; isn't that so?
> A. That is right.
> Q. But that would come out of the funds of the stockholders; isn't that so?
> A. Yes.
> Q. So that a stockholder could never know in a company where the form of compensation was option warrants what his management was going to cost him; isn't that so?
> A. Well, of course, opposing that is that the stockholders benefit by the rise in value theoretically due to management, so that * * *.
> Q. I understand that, Mr. Shields, but you take the circumstance where the asset value goes up to \$100. You exercise your option warrants and you get a stock which has a greater asset value and then you sell your stock; isn't that so?
> A. That is right.
> Q. And then after that, if the management was unsuccessful, and the price declined, you didn't have to contribute back the difference that the trust lost by virtue of the decline?
> A. No.
> Q. You say you're clear in your own mind that you think that this in an undesirable way of compensating management, looking back in retrospect?
> A. Yes; I think it is one of the undesirable ways. I don't know whether I can offer a desirable way, but I don't think this is good.

[253] See note 240, supra. Typical exculpatory provisions were as follows:

> We shall expect of you [the managers] your best judgment in rendering these services to us [the investment company] and we agree as an inducement to your undertaking the same that you shall not be liable hereunder for any mistake of judgment or in any other way whatsoever except for lack of good faith.
> Neither the management company nor any of its directors, officers, agents or employees shall be personally liable or accountable to the Fund or its stockholders for errors of judgment in connection with purchases, holdings, or sale of securities or otherwise in managing the investment of the assets of the fund or rendering any services to the fund, or for any loss arising out of any investment or other transaction or for act or omission to act performed or omitted by the management company or any of its employees or for anything whatsoever except for its own individual wilful misfeasance.

[254] A typical provision of this character is as follows:

> Neither the firm [the managers] nor any member or employee thereof shall be liable to the corporation or any stockholder or creditor thereof or to any other person by reason of such contract or transaction [between the manager and the investment company] or for any loss occurring therefrom, provided that such contract or transaction shall, at the time at which it was entered into, have been a reasonable one to have been entered into, and shall have been on terms that at the time were deemed fair by the Board of Directors of the corporation.

to the reasonableness and fairness of a self-dealing transaction from the viewpoint of the stockholders was obtainable.

The "control" value of management contracts may be illustrated by the cases of the Calvin Bullock and Tri-Continental Corporation groups of investment companies, Iroquois, Share Corporation, and Federated Capital Corporation, which are discussed below.

a. Calvin Bullock Group

The Calvin Bullock group illustrated the ease with which investment companies can be controlled through management contracts by individuals who have no substantial investment in any of the companies. Calvin Bullock, a New York joint stock association which was primarily a selling organization, acted as promoter, underwriter, distributor, and manager of 12 management investment companies. The greatest source of revenue of Calvin Bullock from its distributing contracts was due largely to the public demand for the different types of shares of investment companies that Calvin Bullock organized and sponsored.[255] Although recently management has been receiving greater emphasis as a source of income, distribution is still of primary importance to the Bullock organization if it is to continue on its present scale of operation.[256]

In no instance did Calvin Bullock hold actual or working voting control of any of the companies in its group.[257] Control by Calvin Bullock was exercised and maintained through common and interlocking boards of directors, through management contracts, and through control of proxy machinery. At the year-end 1935, Calvin Bullock held management contracts with all the investment companies of the group. All of these contracts were entered into at the time the companies were organized, with the exception of the contracts with Dividend Shares, Inc., and Nation-Wide Securities Company.[258]

Calvin Bullock management contracts were of three types. One type used in the case of International Superpower Corporation and Carriers and General Corporation, was for the management of closed-end investment companies specializing in certain types of investment. The management fee in both of these cases equaled one-half of 1%

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[255] See Ch. III of this part of the report, pp. 829–32.

[256] Public Examination, Calvin Bullock Trusts, at 4222–3. At the year-end 1935, there were six management companies in the Calvin Bullock group, as follows (replies to Commission's questionnaires for the respective companies, Pt. I):

Name of company:	*Date of organization*
Carriers and General Corporation	Aug. 6, 1929
Dividend Shares, Inc	July 23, 1932
Bullock Fund, Ltd	Jan. 26, 1932
Nation-Wide Securities Co. (Maryland)	June 8, 1932
Canadian Investment Fund, Ltd	Nov. 16, 1932
United States Electric Light & Power Shares, Inc	June 8, 1932

It will be observed that all of these companies, with the exception of Carriers and General Corporation, were organized in 1932 and were of the open-end variety. Bullock Fund, Ltd., represented a consolidation of Bullock Fund, Ltd. (a predecessor corporation), and International Superpower Corporation, organized September 27, 1928 (Replies to Commission's questionnaire for the respective companies, Pt. I).

[257] Replies to the Commission's questionnaire for the respective companies, Pt. V. Such management agreements as may have been executed by United States Electric Light & Power Shares, Inc., were not supplied to this Commission, and hence the affairs of this company have been eliminated from the following discussion.

[258] Replies to the Commission's questionnaire for the respective companies, Pt. I.

of the average net worth of the corporation per annum, and these contracts were made for definite periods of 10 years each. The International Superpower Corporation contract provided as follows with respect to the functions of Calvin Bullock as manager:[259]

It is understood that you are to have complete and exclusive authority to develop and handle for us any business of this type which you may consider advantageous for us, provided, however, that the final decision with respect to the purchase or sale of any security or the conclusion of any other transaction shall rest with our Board of Directors, except to the extent that our Board may specifically from time to time delegate authority in this respect to you. You will attend to such clerical and accounting work for us as we may specify and also furnish us with such statistical information with respect to the securities which we may hold or contemplate purchasing as we may request.

In consideration of your services hereunder, you will receive a quarterly fee of one-eighth of one percent (1/8 of 1%) of the average net worth of the corporation during the preceding quarter, such fee to be paid on the 1st days of February, May, August, and November in each year.

This Agreement shall continue in effect for a period of ten (10) years from the date hereof.

The second type of contract used by Calvin Bullock was employed in all of the open-end investment companies organized by this firm in 1932, with the exception of Canadian Investment Fund, Ltd. These contracts carried fees of one-fourth of 1% per annum of net assets, computed quarterly, except Dividend Shares, Inc., which was at the rate of one-half of 1% per annum of net assets. These contracts were for definite terms from one to five years, and then were automatically renewable on a yearly basis.

The third type of management contract, the sole example of which was the contract of Canadian Investment Fund, Ltd., differed from the second type in that the fee was computed on income rather than on assets. From the operations of Canadian Investment Fund, Ltd., Calvin Bullock was to receive an annual fee of 7½% of the adjusted net profits of the corporation.[260]

The total net assets possessed by the management investment companies in the Calvin Bullock group amounted to in excess of $45,000,000 at December 31, 1935, at which time the stock holding of Calvin Bullock and associates represented approximately $120,000 thereof.[261] Total gross management income received by Calvin Bullock from the various management companies aggregated $565,000 for the period 1928 to 1935, inclusive.[262] In the year 1935, Calvin Bullock received

[259] Reply to the Commission's questionnaire for International Superpower Corporation, Pt. I.

[260] Adjusted net profits were defined to mean all income, including realized profits, after expenses, including income taxes, management compensation and directors' compensation, and after the deduction of unrealized depreciation (Reply to Commission's questionnaire for Canadian Investment Fund, Ltd., Pt. I). It should be pointed out that the by-laws for Canadian Investment Fund, Ltd., required that a sum equal to the amount payable under the management contract, based on adjusted net profits, be paid to those members of the board of directors who were not affiliated with Calvin Bullock. In addition, the original management contract provided that compensation of outside directors should not be less than a minimum of $1,200 to each director annually (ibid.).

[261] Op. cit. supra, note 258, Pts. II, IV, and V.

[262] Public Examination, Calvin Bullock Trusts, at 3757. From the point of view of the investor, the payment of management fees, covering only certain items of expense may be confusing. The prospectus of Dividend Shares, Inc., for instance, stated that the manage-

total gross income from management amounting to approximately $151,000 and expended $125,000 as the cost of managing, showing a net profit of $26,000 for the year. However, of the $125,000 of expense, over 50% was accounted for by salaries.[263] The management expenses were not allocated to individual trusts, the management fees being placed into the "general pot." [264]

The management contracts between Calvin Bullock and the various companies of the group apparently constituted an effective means of control. In this connection, Calvin Bullock, in addition to being the investment manager, was also the sponsor, and the distributor of the security issues of these investment companies. The mechanics employed by Calvin Bullock, as the original sponsor, was to elect representatives of Calvin Bullock to the board of directors,[265] which in turn would appoint Calvin Bullock as distributing agent and enter into the management contract with Calvin Bullock. Thus, the investment companies commenced operations under the control of Calvin Bullock which firm was in a position to perpetuate its position through control of the proxy machinery and through the management contracts.

b. Tri-Continental Corporation

The case of Tri-Continental Corporation illustrates the effectiveness of management contracts, not only to perpetuate a dominant influence in that investment company, but also as a means of pyramiding control of several investment companies without the necessity of any substantial stock ownership either in the parent or the subsidiary companies. On January 1, 1930, Tri-Continental Corporation was incorporated under the laws of Maryland, as a consolidation of a former Tri-Continental Corporation and Tri-Continental Allied Company, Inc., both organized successively in 1929 by J. & W. Seligman & Co., New York investment bankers.[266] At the time of consolidation, the combined assets of the new Tri-Continental Corporation amounted to $75,302,000.[267] The new Tri-Continental Corpora-

ment fee was to be one-half of 1% of net assets per annum, computed quarterly (Reply to Commission's questionnaire for Dividend Shares, Inc., Pt. I). The impression of the investor may have been that this fee, if it did not cover all the expenses of the corporation, at least covered the major part. In reality, in the years 1934 and 1935 for example, the total operating expenses of Dividend Shares, Inc., amounted to 18.5% of total ordinary income, of which management fees represented 7.8% and other expenses, 10.7% (id., Pt. II). This general ratio is also found in other companies, so that actual operating expenses, other than management fees, were at least 1⅓ to 2½ times as great as the management fees (Replies to the Commission's questionnaire for the respective companies, Pt. II). These various companies did not pay fees or salaries to the officers and directors of Calvin Bullock. They were presumably covered by the management fees paid to Calvin Bullock.

[263] Public Examination, Calvin Bullock Trusts, at 3767.

[264] Id., at 3772.

[265] Calvin Bullock controlled the entire boards of directors in all companies in the group except Carriers and General Corporation and Canadian Investment Fund, Ltd.

[266] Summary statement filed with the Commission for Tri-Continental Corporation and Tri-Continental Allied Company, Inc.

[267] Public Examination, Tri-Continental Corporation, at 18551. Additional mergers were effected with Wedgewood Investing Corporation in February 1931, with Investors Equity Company, Inc., in May 1932, and with Graymur Corporation in January 1933. In this way Tri-Continental Corporation sought to counteract the declining market value of its portfolio (Reply to the Commission's questionnaire for Tri-Continental Corporation, Pt. I).

tion was managed by J. & W. Seligman & Co., who did not have controlling stock ownership in the company.[268]

A management contract between J. & W. Seligman & Co. and Tri-Continental Corporation was not executed until October 9, 1931, or two years after the formation of the consolidated corporation. This contract was apparently merely written evidence of the relationship which had always existed between the corporation and its broker sponsor.[269] Earle Bailie, chairman of the board of directors of Tri-Continental Corporation, when examined as to the considerations which motivated the reduction of this relationship to a written management contract testified:[270]

Q. * * * Why was the first management contract between Tri-Continental and Seligman initiated two years after the corporations were started? That was in 1931, wasn't it?

A. Yes. The reason was, at that time, as you will remember from looking at the market prices of the securities and as you will remember from the general market conditions, investment company equity securities were selling at very low prices, and there were several groups of capitalists or investors, describe them as you will, who were busily acquiring the equity securities of investment companies in order to take over their managements and in order to build up other companies. With the interest we had in Tri Continental because of our sponsorship and with the feeling of responsibility we had, we wished to ask the stockholders whether or not they wanted to have a definite management contract with us, which would prevent that happening to the Tri-Continental. We submitted the management contract and it was approved.

Under this contract, the sponsor was to "supervise and assist in the management and usual business affairs of the corporation" and was to "nominate and provide" at lease six persons to serve as directors and members of the executive committee of Tri-Continental Corporation. Of these six persons (out of a board numbering 16 at December 31, 1935) at least three were to be members of the firm of J. & W. Seligman & Co., and of these three, one was to serve as chairman of the board of directors and as president of Tri-Continental Corporation and the other two were to serve as vice presidents of the investment company. In return Tri-Continental Corporation was required to use J. & W. Seligman & Co. as its broker at the customary and usual charges and to use its best efforts to cause "any and all other corporations owned, controlled, and managed by it" to use J. & W. Seligman & Co. as their broker.[271]

The management contract was not terminable by either J. & W. Seligman & Co. or Tri-Continental Corporation without the consent

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[268] At December 31, 1935, affiliated interests owned less than 7% of the voting stock of Tri-Continental Corporation. (See Pt. Two [House Doc. No. 70, 76th Cong.] Ch. V, p. 422.)

[269] Public Examination, Tri-Continental Corporation, at 18647–52 and Commission's Exhibit No. 2084.

[270] Id., at 18645–6.

[271] Id., Commission's Exhibit No. 2084. An additional safeguard was inaugurated in conjunction with the written management contract in order to restrict the possibilities of the management losing its control (id., at 18646–7). This was, in brief, a reclassification of the board of directors from one which had been elected annually into a board of directors consisting of five groups, one-fifth of which was to retire at each annual meeting with successors elected at that time. (See supra, p. 1882.)

of the other party prior to January 1, 1934. After that date either party could cancel the contract on 90 days' notice—such action by Tri-Continental Corporation to be pursuant to a majority vote of those directors not nominated by J. & W. Seligman & Co. and approved by an affirmative vote of the holders of a majority of the shares of each class of stock, at a special meeting of the stockholders called for the purpose. Unless the agreement was terminated by notice of cancelation from J. & W. Seligman & Co. or Tri-Continental Corporation, it was to continue in force until December 31, 1947. Thereafter the agreement was to be automatically renewed for five-year periods, subject to six months' notice of termination.[272]

This management contract had a definite control value to J. & W. Seligman & Co.[273] despite the fact that the latter was not receiving any supervisory or management fees other than brokerage commissions.[274] By providing six members of the board of directors and the executive committee, and three of the principal officers of the investment company, J. & W. Seligman & Co., virtually without any stock ownership, had in effect a substantial voice in the management of Tri-Continental Corporation and, therefore, of its various subsidiaries and affiliates.

During the period 1931 to 1935, inclusive, Tri-Continental Corporation acquired control over several investment companies, one investment management company, and one fire insurance company. This control was also facilitated in several instances by management contracts.

In May 1931 Tri-Continental Corporation purchased stock representing approximately 25% of the voting power in Selected Industries, Inc.,[275] and acquired as part of this deal a management contract providing for a fee at the annual rate of one-half of 1% of the average aggregate value of the gross assets as well as options covering 200,000 shares of the common stock of Selected Industries, Inc., exercisable at any time during the life of the management contract at $15 a share.[276] The nomination of two directors, to serve as chairman and president of Selected Industries, Inc., and the naming of up

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[272] Op. cit. supra,, note 269, Commission's Exhibit No. 2084.

[273] J. & W. Seligman & Co., Inc., at no time possessed voting control over Tri-Continental Corporation (Reply to the Commission's questionnaire for Tri-Continental Corporation, Pt. VIII, Item 77).

[274] Prior to January 1, 1934, J. & W. Seligman & Co. was not to receive any fee for services under the agreement, nor were the persons provided by the sponsor as directors and officers to receive any salaries. In order that salaries could be paid after January 1, 1934, approval was required by a majority of the independent directors and by the stockholders of the corporation. Such salaries had not been paid up to the year-end of 1936. However, with the formation of Union Securities Corporation by Tri-Continental Corporation and Selected Industries, Inc., in October 1938, it was contemplated that partners of J. & W. Seligman & Co. who were also officers or directors of the investment companies would serve as executive officers of the new Corporation and might be compensated after December 31, 1938, on a salary or profit-sharing basis. J. & W. Seligman & Co. was to cease to engage in the investment banking business so long as its members were executive officers of the new corporation but would continue its brokerage, investment counsel and other businesses (Derived from supplementary information supplied the Commission for Tri-Continental Corporation).

[275] Reply to the Commission's questionnaire for Tri-Continental Corporation, Pt. VIII (Item 78).

[276] Op. cit. supra, note 269, at 18559–60, and the reply to the Commission's questionnaire for Selected Industries, Inc., Pt. I.

to three vice presidents, were reserved to Tri-Continental Corporation.[277] The agreement was to continue to December 31, 1934, and was renewable automatically from year to year thereafter. Either party could terminate the agreement at any year-end upon six months' written notice.[278]

In June 1932, Tri-Continental Corporation purchased 64% voting control of the Broad Street Management Corporation,[279] the principal assets of which consisted of a controlling interest in Capital Administration Co., Ltd., a closed-end investment company, a smaller interest in The Broad Street Investing Company, Inc., an open-end investment company, and management contracts with both of these companies.[280] Tri-Continental Corporation, by the terms of a management contract entered into with Broad Street Management Corporation,[281] was to furnish investment advisory services and to suggest four persons to serve as members of the board of directors and as the executive committee, as well as four persons (who could be the same suggested as directors) to serve as the principal officers of Broad Street Management Corporation, Capital Administration Company, Ltd., and The Broad Street Investing Company, Inc. In return, Tri-Continental Corporation was to receive one-half of the gross service fees which Broad Street Management Corporation received through its management contracts from Capital Administration Company, Ltd. and The Broad Street Investing Company, Inc.[282] Broad Street Management Corporation was to pay its own business expenses, excluding the expenses Tri-Continental Corporation incurred in the performance of its duties under the contract. Actually, Tri-Continental Corporation furnished all but two of the principal officers of Capital Administration Company, Ltd., The Broad Street Investing Company, Inc., and Broad Street Management Corporation. These officers served without compensation from those companies for their services as such officers.

Through an investment of approximately $302,000 (later increased to $482,000) in Broad Street Management Corporation, Tri-Contental Corporation gained control over, or the supervision of more than $6,000,000 of assets consisting of cash and securities.[283] As of September 30, 1939 these funds had increased to about $11,600,000.[284]

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[277] In connection with this, it may be pointed out that, at the year-end 1935, of the 13 directors of Selected Industries, Inc., four represented Tri-Continental Corporation and J. & W. Seligman & Co. interests and four represented original sponsors of Selected Industries, Inc. (Reply to the Commission's questionnaire for Selected Industries, Inc., Pt. VII).

[278] As a result of this contract Tri-Continental Corporation received service fees totaling $520,190 for the three-year period 1932 to 1935, inclusive (Reply to the Commission's questionnaire for Selected Industries, Inc., Pt. VI).

[279] Op. cit. supra, note 275, Pt. VIII (Item 78).

[280] Replies to the Commission's questionnaire for Capital Administration Co., Ltd., and The Broad Street Investing Company, Inc., Pts. I and VIII, and derived from supplementary information supplied the Commission for Tri-Continental Corporation.

[281] Derived from supplementary information supplied the Commission for Tri-Continental Corporation.

[282] Inasmuch as Tri-Continental Corporation held 64% of the stock of Broad Street Management Corporation, 64% of the remaining earnings of Broad Street Management Corporation after the payment of expenses would accrue to Tri-Continental Corporation.

[283] Op. cit. supra, note 269, at 18583–4, and op. cit. supra, note 281.

[284] Derived from supplementary information supplied the Commission for The Broad Street Investing Company, Inc., and Capital Administration Company, Ltd.

Thus, the situation was presented whereby an investment banking and brokerage house managed an investment company, which in turn managed a management company, which in turn managed two investment companies. During 1936 when Broad Street Management Corporation became Broad Street Sales Corporation, the management contracts of The Broad Street Investing Company, Inc. and Capital Administration Company, Ltd., were assigned to Tri-Continental Corporation.[285]

In addition, on November 14, 1935, a group consisting of Tri-Continental Corporation, Selected Industries, Inc., and three other companies purchased an aggregate 80% interest in Blue Ridge Corporation, an investment company, from Shenandoah Corporation, another investment company.[286] Tri-Continental Corporation acquired approximately 23% voting control, and Selected Industries, Inc. acquired 7%.[287] Tri-Continental Corporation purchased 1,877,519 shares of Blue Ridge Corporation common stock.[288] Tri-Continental Corporation and other members of the purchase group set aside certain of these shares for resale at a specific price. The number of shares set aside by Tri-Continental Corporation for this purpose totaled 646,750. To carry these shares until they could be resold Tri-Continental Corporation borrowed over $2,000,000 from the Guaranty Trust Company of New York for six months at 1% interest.[289] Selected Industries, Inc. also borrowed a proportionate amount on the same terms in order to carry those shares which it held for resale. In addition, both Tri-Continental Corporation and Selected Industries, Inc. were compelled to sell certain of their portfolio securities to provide cash for this investment.[290]

Pursuant to an understanding had at about the time of purchase of the Blue Ridge Corporation stock, Tri-Continental Corporation and Northern Shares Company, Inc., a New York corporation affiliated with the Harrison Williams group of companies, subsequently entered into a management contract with Blue Ridge Corporation which was approved by the latter's stockholders. The management contract [291] provided that Tri-Continental Corporation and Northern Shares Company, Inc., should jointly or separately furnish investment advice and service to Blue Ridge Corporation and its wholly owned subsidiaries and Tri-Continental Corporation and Northern Shares Company, Inc. were to divide equally the management fee of four-tenths of 1% per annum of the assets of Blue Ridge Corporation.[292] The contract was to continue in effect until the year-end 1937 and automatically from year to year thereafter. Either Tri-Continental Corporation or Northern Shares Company, Inc. or Blue

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[285] Derived from supplementary information supplied the Commission for The Broad Street Investing Company, Inc., and Capital Administration Company, Ltd. (1936 annual reports).

[286] Op. cit. supra, note 281.

[287] Replies to the Commission's questionaire for Tri-Continental Corporation and Selected Industries, Inc., Pt. VIII.

[288] Op. cit. supra, note 275, Pt. VIII.

[289] Op. cit. supra, note 281.

[290] Ibid.

[291] Reply to Commission's questionnaire for Blue Ridge Corporation, Pt. I.

[292] Op. cit. supra, note 281.

Ridge Corporation could terminate the contract on December 31, 1937, or at any year-end thereafter upon 90 days' notice.

At December 31, 1936, J. & W. Seligman & Co., primarily by means of management contracts, had control over or a substantial influence in the investment of assets totaling over $170,000,000.[293]

c. Iroquois Share Corporation

The management contract of Iroquois Share Corporation sought to broaden the powers of the management and had to be reckoned with in working out an exchange offer with Atlas Corporation. Iroquois Share Corporation was organized under the laws of New York on January 14, 1929, by its sponsors, O'Brian, Potter & Stafford, members of the New York Stock Exchange. On April 6, 1931, it was acquired by Atlas Corporation and was dissolved on November 30, 1931. The original subscribed capital amounted to $3,707,694.[294]

During the period of sponsorship by O'Brian, Potter & Stafford and Walter F. Stafford, it operated under two management agreements. The first contract, which was to run for 10 years, was entered into on January 23, 1929, between the investment company and O'Brian, Potter & Stafford, prior to the public offering and before the election of outside directors to the board. Under this management contract [295] the sponsors were to receive compensation at the rate of one-half of 1% of the net worth of the investment company annually. Additional compensation for the management was provided by three-year option warrants granted to the sponsors for the purchase of 50,000 shares of the capital stock at $20 a share.[296]

While the articles of incorporation of the investment company contained no provision permitting self-dealing and the prospectus never informed the public of any intention to engage in self-dealing, the management contract provided in very broad terms complete immunity to the sponsors, officers, and directors of the trust for any contract or transaction made with the companies in which they might be directly or indirectly interested.[297]

Because of the extended (10-year) period of the management contract, the stockholders had either to endure the management, no matter how unsuccessful, or to buy their way out. This was conceded by Walter F. Stafford, president of Iroquois Share Corporation, when he testified: [298]

> Q. And also had this ten-year contract, so that if any steps were desired to be taken by the stockholders, they would have to deal with O'Brian, Potter and Stafford with relation to that management contract?
>
> A. It would work out that way; yes, sir.

On July 28, 1930, a deal was worked out with O'Brian, Potter & Stafford, the sponsors and managers, whereby they agreed to cancel their management contract if the investment company would

[293] Op. cit. supra, note 269, at 18539–40.
[294] For full details see Ch. II of this part of the report, pp. 51–76.
[295] Public Examination, Iroquois Share Corporation, Commission's Exhibit No. 1393.
[296] Id., at 19858–9.
[297] Id., at 13953–4.
[298] Id., at 13952.

purchase from that firm an unfinished office building, known as 17 Court Street, for $313,616.[299] This was done, and eventually the investment company suffered a loss of its entire investment in this office building. On July 28, 1930, a second, five-year, management contract effective September 15, 1930, was entered into with Walter F. Stafford personally after he had resigned from the firm of O'Brian, Potter & Stafford.[300] The basis of compensation under the new management contract was changed from a percentage of the net worth to a flat sum of $25,000 per annum plus a bonus of 5% above net earnings of $1 per share per year on all stock of Iroquois Share Corporation issued and outstanding. This annual fixed compensation substantially exceeded the management compensation which had been derived under the original contract even in 1929 before the market collapse.[301] Despite the cancelation of the first management contract, O'Brian, Potter & Stafford retained the option warrants received as part of their management compensation.[302]

Mr. Stafford performed for less than a year under the new management contract when Iroquois Share Corporation found it to be an obstruction to a proposed exchange offer by Atlas Corporation of its securities for the securities of Iroquois Share Corporation, a proposition which in effect was a proposed merger of the two companies. Mr. Stafford testified:[303]

Q. * * * Now, the fact of the matter was in this particular instance, although the board of directors decided that it would be to the best interests to turn over control to the Atlas Corporation, the problem of your manegement contract was not only a regular one but was a very vital one, isn't that so?

A. That is true.

Q. The fact of the matter is, as I recall it, you were in a position, unless you could be settled with, you could possibly impede the transfer of the investment trust unless they canceled the management contract?

A. Well, I think that is a legal question, but as a businessman I would say that that was so.

A special committee was appointed to negotiate for a release of the management contract of Iroquois Share Corporation with Walter F. Stafford, and this committee recommended that Mr. Stafford be offered $50,000 in full settlement. This offer was rejected by Mr. Stafford, and the investment company was compelled to meet his demand for $75,000 in order to effectuate the exchange offer.[304] Mr. Stafford had received $11,458 for his services performed under the contract during the period July 1930 to April 1931[305] while he and the firm of O'Brian, Potter & Co., the successor of O'Brian, Potter & Stafford, received Atlas Corporation option warrants, having a minimum market value of $50,212.50, for their option warrants of Iroquois Share Corporation which they had obtained without cost.[306]

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[299] Id., Commission's Exhibit No. 1397. For details of this acquisition and the losses suffered see Ch. II of this part of the report, pp. 51–76.

[300] Op. cit. supra, note 295, Commission's Exhibit No. 1404.

[301] On the basis of the old compensation the managers would have received only $7,500 (Reply to the Commission's questionnaire for Iroquois Share Corporation, Pt. II).

[302] Op. cit. supra, note 295, at 14010, and Commission's Exhibit No. 1397.

[303] Id., at 14021.

[304] Id., Commission's Exhibit No. 1407.

[305] Id., at 13963.

[306] See Ch. II of this part of the report, pp. 51–76.

The difficulties met by stockholders who may decide to obtain better management of their investment company in the face of an existing long-term management contract, was described by Mr. Stafford as follows: [307]

Q. Well, do you know what particular harm there would be done to the investors if provision was made that no management contracts should last more than a year and that the renewals should be subject to the approval of the stockholders? In this particular case, Mr. Stafford, no matter how your performance was, as long as you were honest, the stockholders would have to keep you there, isn't that so?

A. Yes.

Q. And if they didn't want to keep you, they would have to pay you the balance of your contract of $25,000 at least, so that if you were incompetent—when I say "you" I mean I am talking hypothetically——

A. I understand.

Q. (Continuing.) And you show the world's worst performance, but as long as you don't put your hand on the "till," there was nothing they could do about it?

A. Now, that is a legal question again, but I think you are right.

Q. Now, in this particular case, too, if the trust was losing money and there was further shrinkage of assets, you still would be entitled to your $25,000; isn't that so?

A. Under the contract.

d. Federated Capital Corporation

The management contract of Federated Capital Corporation was an important feature of the transfer of control of the company to Atlas Corporation. On April 7, 1927, Federated Capital Corporation was organized under the laws of Delaware by a group headed by William J. Thorold.[308] From April 22, 1927, to May 15, 1931 (the date control passed to Atlas Corporation), the total paid-in capital aggregated $6,122,680, about half in common stock and half in preferred stock.[309]

By an exchange of letters dated April 25 and April 28, 1927, a management contract was entered into with Federal Debenture Company, Inc., a company in which Mr. Thorold had a substantial stock interest, without disclosure to the stockholders of the investment company. Mr. Thorold testified concerning this contract as follows: [310]

Q. In any event, so far as your reports to stockholders are concerned, as I read them, there was no disclosure even that there was a management contract in existence?

A. No; or that anybody got a salary of any kind.

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[307] Op. cit. supra, note 295, at 14027.

[308] Reply to the Commission's questionnaire for Federated Capital Corporation, Pt. I.

[309] Public Examination, Federated Capital Corporation, Commission's Exhibit No. 1476.

[310] Id., at 14543.

Q. Or that a bonus was paid you?

A. No.

Q. Or what the amount of your salary was?

A. No; it was not customary.

This contract, which ran for five years, was superseded on February 25, 1929, by another contract between the investment company and Federated Management Company, which was also owned by Mr. Thorold. This contract was to extend for 10 years, thus binding stockholders to this manager for a long period of time regardless of the character of performance.[311] Mr. Thorold testified regarding the duration of the management contract:[312]

Q. * * * This was a ten-year contract?

A. Yes, sir.

Q. That you gave yourself at the very inception of the investment trust?

A. Yes, sir.

Q. So that for a period of ten years * * * regardless of what your performance was, because your compensation was not predicated upon performance but upon capital employed?

A. Yes, sir.

Q. And regardless of what they thought of your expert management and regardless of what the results of the trust was, if you were not guilty of fraud and dishonesty, the stockholders would have to keep you as their manager, isn't that so?

A. Well——

Q. Or else pay you the balance of the term of the contract and tell you that they were through?

A. But on so many occasions we had not insisted upon the letter of the contract, and we have "forewent"—if there is such a word—several moneys, and we probably would have canceled it.

The management compensation payable to Federated Management Corporation, in which Mr. Thorold also held virtually all of the stock,[313] was fixed at one-half of 1% per annum of the gross amount of capital employed by the investment company, payable on the tenth day of each month.[314] In addition, Federated Capital Corporation provided the management company with office accommodations and a clerical staff and paid a salary to Mr. Thorold for acting as president.[315] In 1929, when the investment company enjoyed a successful year, not only was the salary of Mr. Thorold increased from

[311] Op. cit. supra, note 308, Pt. I.

[312] Op. cit. supra, note 309, at 14491.

[313] Id., at 14466.

[314] Id., Commission's Exhibit No. 1474.

[315] Op. cit. supra, note 308, Pts. II and VII. The gross amount of capital employed included borrowed moneys. Thus, the management compensation was computed upon $900,000 borrowed by the investment company in October 1929 (op. cit. supra, note 309, at 14472–4).

$20,000 to $30,000, but he was voted a bonus of $50,000.[316] Mr. Thorold expressed the opinion that from his experience everything concerning the reward of management should be published to the stockholders, the compensation for management should be made contingent upon results, and the period covered by management contracts should not average over three years.[317]

On May 15, 1931, Federated Management Corporation assigned its management contract to the Atlas Corporation for $85,000.[318] Mr. Thorold testified concerning this assignment:[319]

Q. * * * You sold your management contract, didn't you?

A. Yes, sir.

Q. And what did you get for it?

A. $85,000. I did not personally get it.

Q. No; the Federated Management Corporation, of which you were the sole stockholder, got it?

A. Yes; but it had been offered $160,000 for it.

As a part of the transaction wherein Atlas Corporation purchased an assignment of the management contract from the sponsor for $85,000, the sponsor realized a substantial gain over the market price in the sale of his preferred shares in the investment company. In addition Federated Management Corporation, substantially owned by Mr. Thorold, received $20 a share ($6 in excess of market value and $4.50 less than asset value) for their 8,000 shares of preferred stock. Atlas Corporation thus paid a premium of $48,000 in excess of the market value to the sponsor and his associates for their stock.[320] This stock was sold by the sponsor to the Atlas Corporation, and the management of Federated Capital Corporation was turned over to the Atlas Corporation without apprising the stockholders.[321] Subsequently, Atlas Corporation succeeded in acquiring most of the shares of Federated Capital Corporation for a total consideration substantially less than the asset value of such securities, either by purchase or by exchange offers of its own securities.[322]

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[316] Op. cit. supra, note 309, at 14484. In the year 1931, when the investment company experienced a realized loss of $809,000 and its assets depreciated by $2,000,000, Mr. Thorold's salary was again increased from $30,000 to $36,000 (id., at 14489).

[317] Op. cit. supra, note 309, at 14540.

[318] Id., at 14590.

[319] Id., at 14486.

[320] Id., at 14591–4.

[321] Id., at 14599.

[322] For further details of this acquisition by Atlas Corporation, see Ch. IV of this part of the report, pp. 1278–92.

APPENDIX I.—*Proportion of total capital of four investment companies contributed by senior and junior security holders and sponsor's interest therein*

REYNOLDS INVESTING CO., INC.

Securities	Relationship of senior and junior capital: Gross capital contribution	Percent of total capital contributed	Percent of voting power	Percent of participation in surplus profits	Sponsor's int.: Amount invested	Percent of total investment contributed by sponsor	Percent held	Percent of total voting power	Right to participate in surplus profits
Senior capital									
5% debentures (with warrants for 5 shares of common stock per $1,000 debentures at no cost)	$5,000,000	------	None	None	None	None	None	None	None
$6 preferred stock (in units with one share of common stock)	3,000,000	------	None	None	None	None	None	None	None
Total senior capital	8,000,000	86.4	None	None	None	None	None	None	None
Junior capital									
Common stock (subscription by sponsors to 100,000 shares for $1,000,000, 30,000 shares for $10 each in units with preferred stock and 25,000 shares upon exercise of warrants at no cost)	1,300,000	------	100	100	$1,000,000	76.9	64.5	[a] 64.5	64.5
Total junior capital	1,300,000	14.6	100	100	1,000,000	76.9	64.5	[a] 64.5	64.5
Total capital	9,300,000	------	------	------	1,000,000	10.7	------	[a] 64.5	64.5

[a] As of Apr. 15, 1929, date at which warrants attached to debentures and preferred stock were declared exercisable; prior to that date control was actually 100% since warrants were nondetachable from debentures and preferred stock until declaration of dividend on common, redemption of the debentures or preferred stock or at option of the company.

THE INVESTMENT CO. OF AMERICA

Securities	Relationship of senior and junior capital				Sponsor's interest				
	Gross capital contribution	Percent of total capital contributed	Percent of voting power	Percent of participation in surplus profits	Amount invested	Percent of total investment contributed by sponsor	Percent held	Percent of total voting power	Right to participate in surplus profits
Senior capital									
5% debentures	$4, 850, 000	------	([b])	None	None	None	None	([b])	None
7% preferred stock	[a] 6,000,000	------	([b])	None	None	None	None	([b])	None
Total senior capital	10, 850, 000	77. 9	([b])	None	None	None	None	([b])	None
Junior capital									
Common stock (60,000 with preferred and 90,000 by rights)	[a] 2,901,483	------	([b])	100	None	None	None	([b])	None
Warrants (100,000 to public, and 210,000 to sponsors)	[c] 180, 000	------	([b])	None	$180, 000	100	67. 7	([b])	None
Total junior capital	3, 081, 483	22. 1	([b])	100	180, 000	5. 8	------	([b])	None
Total capital	13, 931, 483	------	------	------	180, 000	1. 3	------	([b])	[d]None

[a] The preferred stock is taken here at par value; it had been issued in units with common stock within a short period of time at varying prices per unit.

[b] The Investment Co. of America was a Michigan business trust, the sponsors serving as the self-perpetuating trustees. Hence, share ownership was not required for the exercise of control. The only investment by the sponsors in the organization was a fund of about $180,000 which the trustees contributed to the trust for operating expenses during the first 2 years. This sum represents approximately 1.3% of the total proceeds received by the trust from the sale of its securities.

[c] E. E. MacCrone & Co. paid the expenses of the trust, estimated at not exceeding $180,000, for the first 2 years of operation. In return for this expenditure and for management services, they received, by the terms of the trust indenture, 210,000 warrants.

[d] The common stock as well as the senior securities was distributed to the public. It appears that the objective of the capital set-up of the sponsors in this company was to secure control and the benefits that might subsequently be derived from the exercise of warrants.

AMERICAN CAPITAL CORPORATION

Securities	Relationship of senior and junior capital: Gross capital contribution	Percent of total capital contributed	Percent of voting power	Percent of participation in surplus profits	Sponsor's interest: Amount invested	Percent of total investment contributed by sponsor	Percent held	Percent of total voting power	Right to participate in surplus profits
Senior capital [a]									
5.50 prior preferred (with bonus one-half share B)	$5,970,000	-----	None	None	None	None	None	None	None
3.00 preferred stock (with bonus one-half share B)	5,940,000	-----	None	None	None	None	None	None	None
Class A common stock (issued in units 3 shares A and 2 shares B at $100)	3,266,634	-----	[b] 21.4	(Shared with B stock) [c]	None	None	None	None	None
Total senior capital	15,176,634	97.5	21.4	--------------	None	None	None	None	None
Junior capital									
Class B common stock (156,666 shares with the prior preferred, preferred and Class A stocks; 210,000 shares to directors at $2)	576,666	-----	[b] 78.6	(Shared with A stock) [c]	$420,000	72.8	54.5	44.0	(Shared with class A stock on certain terms) [c]
Warrants (525,000 to directors, 15,000 to Bonbright & Co., Inc.)	----------	-----	None	None	None	None	None	None	None
Total junior capital	576,666	2.5	78.6	--------------	420,000	72.8	54.5	44.0	None
Total capital	15,753,300	-----	------	--------------	420,000	2.7	------	44.0	--------------

[a] The Class A stock is listed under "senior capital" because it possessed a fixed limited priority as to dividends and distribution on liquidation.

[b] Class A shares and Class B shares each had one vote per share.

[c] The Class A stock was entitled to a prior dividend of $2. Dividends were then to be distributed to the Class B stock to a point where each class had received $4, and thereafter there was to be an equal distribution in both classes.

PACIFIC INVESTING CORPORATION

Securities	Relationship of senior and junior capital				Sponsor's interest				
	Gross capital contribution	Percent of total capital contributed	Percent of voting power	Percent of participation in surplus profits	Amount invested	Percent of total investment contributed by sponsor	Percent held	Percent of total voting power	Right to participate in surplus profits
Senior capital									
5% debentures (with bonus of 3 shares common stock per $1,000 bond)	$4,810,000	------	None	None	None	None	None	None	None
6% first preferred stock (bonus of one-half share common)	5,970,000	------	None	None	None	None	None	None	None
$6 second preferred stock (with varying amounts of common)	2,881,250	------	None	None	$222,500	7.7	8.3	None	None
Total senior capital	13,661,250	98.5	None	None	222,500	1.6	------	None	None
Junior capital									
Common stock (11,250 with senior securities and second preferred)	218,600	------	100	100	102,500	46.9	16.8	16.8	16.8
Warrants	(a)	------	None	None	(a)	-------	(a)	None	None
Total junior capital	218,600	1.5	100	100	102,500	46.9	16.8	16.8	16.8
Total capital	13,879,850	------	------	------	[b] 325,000	2.3	------	16.8	16.8

[a] The 5 original directors contributed $90,000 for expenses and received 9,000 shares of common stock and 100,000 warrants or contracts for warrants at organization.

[b] For common and second preferred stocks.